Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, in conflict with the holdings of the Third Circuit in *United States v. Farley*, No. 99-3209, ___ F.3d ___ (3d Cir. 2000) (App. 92) and the Fifth Circuit in *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 62 F.3d 136 (5th Cir. 1995), *aff'g and adopting the opinion of the Tax Court*, 103 T.C. 398 (1994), the Tenth Circuit incorrectly held that tax attributes subject to reduction under 26 U.S.C. § 108(b), including the suspended losses of an S corporation shareholder, must be reduced in the year that discharge of indebtedness income, excluded under 26 U.S.C. § 108(a), is realized, despite the statutory requirement that all tax attributes, including suspended losses, be adjusted in the succeeding taxable year, and only after the determination of tax for the taxable year of the discharge.

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I. PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners David A. and Louise A. Gitlitz and Philip D. and Eleanor G. Winn respectfully request that this Court issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

II. OPINIONS BELOW

The Commissioner of the Internal Revenue issued Notices of Deficiency to Petitioners Gitlitz and Petitioners Winn. Both the Gitlitzes and the Winns timely petitioned the United States Tax Court to review the proposed deficiencies. App. 59 and App. 75. The Tax Court issued an initial opinion on June 24, 1997, reported at T.C.M. (RIA) 97,286 (App. 25). Subsequently, that opinion was withdrawn, and the Tax Court's final opinion was filed on February 19, 1998, reported at T.C.M. (RIA) 98,071. (App. 21). The Gitlitzes and Winns filed timely notices of appeal on April 27, 1998, and the Tenth Circuit affirmed the Tax Court decision in an opinion reported at *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999). (App. 1).

III. JURISDICTION

The Tax Court's jurisdiction arose under §§ 6212, 6213, 6214, and 7442 of the Internal Revenue Code (Title

26).[1] The Tenth Circuit's decision was entered on July 6, 1999, and Petitioners' timely-filed Petition for Rehearing was denied on November 3, 1999. (App. 32). This Petition is timely filed, and this Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

IV. STATUTORY PROVISIONS INVOLVED

Sections 108, 1366 and 1367 of the Internal Revenue Code of 1986 (Title 26 of the United States Code), are set forth in their entireties at App. 34, App. 52 and App. 56, respectively.

V. STATEMENT OF THE CASE

A. RELEVANT FACTS

The facts are not in dispute, and are set out in the parties' cross motions for summary judgment. Documents Nos. 6-8, 12-13 in Tax Court Docket Nos. 5359-96 (Winn) and 5358-96 (Gitlitz).[2] Petitioners David Gitlitz and Philip Winn (collectively, with their spouses, the "Taxpayers") were shareholders of P.D.W.&A., Inc.

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[1] All subsequent citations to the "Code" refer to the Internal Revenue Code of 1986, Title 26 of the United States Code. All statutory citations, unless otherwise specified, refer to that Title. Cites to Regulations or Treasury Regulations likewise refer to 26 C.F.R.

[2] The filed briefs and motions in the Tax Court are virtually identical (only the names have been changed) in *Gitlitz v. Commissioner*, Tax Court Docket No. 5389-96 and *Winn v. Commissioner*, Tax Court Docket No. 5358-96, and have identical docket numbers. For convenience, the term "Document No." refers to the records in both Tax Court cases.

("PDW&A"), a corporation that had elected to be taxed under Subchapter S of the Code. PDW&A realized cancellation of debt ("COD") income in the amount of $2,021,296 in 1991. At the time that it realized this income, PDW&A was insolvent to the extent of $2,181,748. Thus, under § 108(a)(2), PDW&A was entitled to exclude the entire amount of the cancelled indebtedness from income.

On their tax returns, the Taxpayers increased their basis in their PDW&A stock by the amount of their pro rata share of the COD income, pursuant to §§ 1366 and 1367, which generally provide that an S corporation shareholder's stock basis is increased by all items of income realized by the corporation, including non-taxable income. This increase in basis permitted the Taxpayers to deduct individually their shares of prior S corporation losses, which had been previously suspended under § 1366(d)(1) because such losses exceeded shareholder basis.

B. PROCEEDINGS IN THE U.S. TAX COURT

The Commissioner disallowed these losses, asserting that a basis increase was unavailable under the statutes. In the Tax Court, the parties filed cross motions for summary judgment. In his memorandum filed prior to oral argument on the motions, the Commissioner relied primarily upon the argument that the § 108 exclusion operates to defer or postpone the realization or recognition of COD income to a later year, such that COD income is not "tax-

exempt" within the meaning of § 1366(a)(1)(A), and therefore does not pass through to the shareholders and increase their stock basis. (Document No. 16).

However, at oral argument, the Commissioner, for the first time, relied upon Treas. Reg. § 1.61-12, and argued that, because COD income is not "realized," it is not an "item of income" within the meaning of §§ 1366 and 1367. Throughout his argument, the Commissioner took the position that the sole issue to be decided by the Tax Court was whether COD income is "realized" in the year of discharge such that it is an item of income for purposes of § 1366 that must be passed through. Counsel for the Commissioner stated "if the Court finds that excluded COD is an item of income, either tax exempt or otherwise, then we're squarely within Code section 1366, and the basis consequences would flow." (Document No. 20 at p. 31).

On June 24, 1997, the Tax Court issued its opinion in *Winn v. Commissioner*, T.C.M. (RIA) 97,286, *withdrawn and reissued as* T.C.M. (RIA) 98.071. In that opinion the Court held:

> In memoranda filed with the court prior to the hearing on these matters, several arguments were set forth in support of respondent's motions, including the argument that discharge of indebtedness income was 'deferred' and not 'tax exempt income' under § 1366(a) . . . . At the hearing on these matters, however, respondent abandoned those prior arguments and argued the following position:
>
> > If the court were to hold that excluded COD (cancellation (discharge) of indebtedness) is an item of income under § 1366, then you

> would have to find that it flows through to the taxpayers and they increase their basis. Respondent's position is that it's not an item of income and never flows through. . . .

We deal here solely with respondent's 'final' position.

The Tax Court went on to hold that the Commissioner's reliance upon § 1.61-12 of the regulations was misplaced, and that COD income is an item of income within the meaning of § 1366, holding for the Taxpayers.

The Commissioner filed a motion seeking reconsideration. The Commissioner argued in his motion that he had not intended to abandon at oral argument any of the arguments presented in his memoranda, and that his counsel had merely presented a "new alternative argument." (Document No. 24 at p. 2). The Commissioner also noted the existence of numerous other cases on the Tax Court docket containing the same issue. (Document No. 24 at pp. 5-6).

The Tax Court did not rule on the motion for six months. It was only after the issuance of its opinion in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999), which held that the language of § 108(d)(7)(A) (requiring certain provisions of § 108 to be "applied at the corporate level" in the case of S corporations) precluded the passthrough of COD income to shareholders and eliminated any basis increase, that the Tax Court resolved the reconsideration motion. In its second opinion in *Winn v. Commissioner*, T.C.M. (RIA) 98,071, *aff'd sub nom, Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), the Tax Court granted reconsideration, withdrew its prior opinion, and issued an opinion for the Commissioner based upon the *Nelson* opinion. (App. 21).

C. PROCEEDINGS IN THE TENTH CIRCUIT

In its opinion in *Gitlitz*, the Tenth Circuit specifically rejected the Tax Court's position in *Nelson* that § 108(d)(7)(A) prevented the passthrough of COD income. 182 F.3d at 1148. However, the Tenth Circuit ruled for the Commissioner on alternate grounds, holding that COD income is eliminated at the S corporation level (before passthrough) by virtue of being "applied against" shareholder suspended losses, which are treated as a "tax attribute" and subject to reduction under § 108(b).

VI. REASONS FOR GRANTING THE WRIT

The Tenth Circuit departed from the plain language of the Internal Revenue Code in order to deny a perceived windfall to Taxpayers. In reaching its conclusion, the Tenth Circuit relied primarily upon a timing statute, § 108(b)(4)(A), and interpreted that statute to require attribute reduction during, rather than after, the year of debt discharge. The Tenth Circuit's reading of § 108(b)(4)(A), and its ultimate holding that excluded COD income does not increase shareholder stock basis, is squarely contrary to the Third Circuit's opinion in *Farley v. United States*, No. 99-3209, ___ F.3d ___ (3d Cir. 2000). (App. 92)[3] Its construction of § 108(b)(4)(A) to require

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[3] The *Farley* opinion was released on January 27, 2000. As of the time that this Petition was transmitted for printing (January 30, 1999), Westlaw had not yet processed the opinion. The court's opinion in *Farley* was posted on the internet at *http://pacer.ca3.uscourts.gov/recentop/day/993209.txt* A copy of this

attribute reduction during the year of the discharge, rather than after, also conflicts with the Fifth Circuit's construction of that same statute in *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 62 F.3d 398 (5th Cir. 1995), *aff'g and adopting the opinion of the Tax Court*, 103 T.C. 398 (1994).

The courts that have addressed the issue as to the effect of S corporation excluded COD income upon shareholder stock basis have reached disparate conclusions. The specialist Tax Court held for the government in *Nelson v. Commissioner*, 110 T.C. 114 (1998), on grounds that the Tenth Circuit then rejected in *Gitlitz*, 182 F.3d at 1148, and *Nelson*, 182 F.3d 1152 (10th Cir. 1999). The Third Circuit in *Farley* rejected the reasoning of both the Tax Court and the Tenth Circuit and held for the taxpayer. The Seventh Circuit recently held for the Commissioner in the case before it, but its opinion permits a shareholder basis increase for non-taxable COD income and would afford benefits to taxpayers resulting from that increase in later years. *Witzel v. Commissioner*, No. 99-2482, ___ F.3d ___, 2000 WL 30084 (7th Cir. 2000). The district court in Oregon recently held for the taxpayers for reasons similar to those set out in this Petition and in *Farley*. *Hogue v. United States*, 2000 WL 2651 (D.Ore. 2000).

Because the issue affects a significant number of insolvent corporations and their shareholders, many of whose tax cases are pending in Courts of Appeals or other courts throughout the nation, a decision by this

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posting is attached as part of the appendices at App. 92 *et seq.* In this Petition, all citations to *Farley* are to the pagination contained in that posting of the opinion.

Court is necessary to resolve the conflict that exists among the circuits and to assure uniformity of treatment, consistent with the proper application of the tax laws.[4]

A. Discharge Of Indebtedness Income Realized By An S Corporation And Excluded From Income Under 26 U.S.C. § 108 Is An Item Of Income That Increases Shareholder Basis Under 26 U.S.C. §§ 1366 And 1367.

Subchapter S of the Code (26 U.S.C. § 1361 *et seq.*) allows shareholders of qualified corporations to elect a "passthrough" system of taxation under which corporate income, losses, deductions, and credits are directly attributed to the shareholders. *Bufferd v. Commissioner*, 506 U.S. 523, 525 (1993). Income, expenses, and other tax related items of an S corporation are passed through to its individual shareholders. § 1366. If an item of income (taxable or nontaxable) is taken into account under § 1366, the shareholder's basis in the stock of the S corporation is increased by that amount. § 1367(a).

Section 61(a)(12) provides that gross income includes COD income. Section 108(a)(1)(B) provides an exclusion

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[4] Pending cases at the circuit level include *Chesapeake Outdoor Enter., Inc. v. Commissioner*, 4th Cir. No. 98-2627 (in circuit mediation program); *Guidiano v. Commissioner*, 6th Cir. No. 99-1294 (briefing complete, oral argument held December 17, 1999); *Friedman v. Commissioner*, 6th Cir. No. 99-2378 (briefing complete, oral argument held December 17, 1999); *Pugh v. Commissioner*, 11th Cir. No. 99-12646 (briefing complete, oral argument not yet scheduled). Numerous additional cases are pending in the Tax Court, in district courts, and at various administrative levels.

of such income for insolvent taxpayers up to the amount of the taxpayer's insolvency. In the case of an S corporation, subsection (a) of § 108, which determines the amount of the exclusion, is determined at the corporate level. § 108(d)(7)(A).

While COD income is excluded from gross income under § 108(a), there is a price for the exclusion in some, but not all, cases. To the extent that a bankrupt or insolvent taxpayer has what are referred to as "tax attributes" as part of his or her tax profile, section 108(b)(1) provides that "the amount [of COD income] excluded from gross income . . . shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." The attributes potentially subject to reduction under § 108(b) include net operating losses ("NOLs"), capital loss carryforwards, and basis in property. *See* § 108(b)(2)(A)-(G). In the case of S corporations, which do not have NOLs, there is a special rule which requires that individual shareholder losses, suspended because of insufficient shareholder basis under § 1366(d)(1), are to be treated as NOLs for attribute reduction purposes. § 108(d)(7)(B).

Whether excluded COD income realized by the corporation constitutes an "item of income," subject to being passed through for purposes of determining stock basis under §§ 1366 and 1367, is easily resolved by an examination of the statutes. All three Circuit Courts of Appeals and the Oregon district court have concluded that excluded COD income of an S corporation is an "item of income" within the meaning of § 1366. *Farley*, Op. at 13-14, App. at 109-110; *Gitlitz*, 182 F.3d at 1148; *Witzel*, 2000 WL 30084 at *2-*3; and *Hogue*, 2000 WL 2651 at *2. The *Gitlitz* court explained:

> The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation. Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.

182 F.3d at 1148.

The benefit claimed by the Taxpayers in this case, i.e., an increase to shareholder basis that permits the utilization of formerly suspended losses, was thus within the language of the statutes.

B. The Initial Position Of The Commissioner And That Of The Tax Court Have Been Rejected By All Of The Circuit Courts Of Appeals To Have Considered This Issue.

Notwithstanding the clear language of the statutes, the Internal Revenue Service challenged the basis increase on the grounds that excluded COD income did not pass through to shareholders. The Commissioner's position was first articulated in a 1994 technical advice memorandum. TAM 9423003. Virtually all of the commentators concluded that the Commissioner's position was without merit and represented an ill-considered

attempt to legislate tax law through the judicial process.[5] After pointing out the legal and logical flaws in the Commissioner's arguments, the overwhelming majority of commentators concluded that the statutory provisions at issue were clear and unambiguous, and that the IRS must seek an amendment to the Code if it wished to alter the results. Although well aware of the controversial nature of his position, the Commissioner chose neither to pursue corrective legislation, nor even to clarify his position by releasing Treasury Regulations or other published guidance.

Despite the basis rules set out in §§ 1366 and 1367 of the Code, the Tax Court in *Nelson*, agreed with the Commissioner that COD income realized by an S corporation cannot be passed through to the shareholders and used to increase the basis in their stock. The Tax Court based its decision on a provision outside Subchapter S, § 108(d)(7)(A), construing the language of that statute, which provides that subsections (a), (b), (c) and (g) of § 108 are to be "applied at the corporate level," to mean

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[5] *See, e.g.*, AICPA, "Pre-Release Comments Regarding Regulations on Discharge of Indebtedness Income under Internal Revenue Code Section 1366," Apr. 5, 1995 (Reprinted in the BNA Daily Tax Report, April 10, 1995 at G-2); Lipton, "IRS Challenges S Corporation Basis Increase for COD Income," 81 J.Tax'n 340 (Dec. 1994); Lipton, "The Story of the Tortoise and the Hare: Workouts Involving S Corporations," Taxes, April 1994, p. 163; Gore, "Troubled 'S' Corporation That Recognizes COD Income May Yield Substantial Tax Benefits," 9 Tax Mgmt. Real Est. J. 80 (Apr. 7, 1993); Collins and Schneider, "TAM 9423003: The IRS Says Excluded COD Income Does Not Increase S Corporation Stock Basis," 6 J. of S Corp. Tax'n. 348; Eustice, "Financially Distressed S Corporations," 53 Tax Notes 97 (1991).

that COD income was excluded "at the corporate level" and could not be passed through and taken into account at the individual level. 110 T.C. at 121-122.

In reaching this conclusion, the Tax Court overlooked fundamental rules regarding the operation of provisions of Subchapter S of the Code. While under the provisions of § 1361 *et seq.*, S corporations are generally not subject to tax (§ 1363(a)), all items of income and deduction related to activities of the corporation are attributed in the first instance to the corporation, not its shareholders, and the taxable income of an S corporation as an entity is "computed in the same manner as in the case of an individual." § 1363(b). Under this system, "deductions generally allowable to individuals [are] allowed to subchapter S corporations." S. Rep. No. 97-640, 97th Cong., 2d Sess. 15 (1982), 1982-2 C.B. 718 at 724. After corporate level determinations are made, the shareholders' pro rata share of corporate items of income and deduction realized by the corporation must be "taken into account" by the shareholders in determining their individual income tax liability and basis. §§ 1366 and 1367. When the items are passed through to the shareholders, the items are treated as having the same character as they did at the corporate level. § 1366(b).

Commentators have been equally critical of the Tax Court's holding in *Nelson*.[6] The Department of Justice, in

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[6] *See* Williford, "Shareholder is Wrestled Down with a Full Nelson – Interplay of COD and S Corporation Rules," Tax Management Memorandum (August 3, 1998); Lipton, "Tax Court Rejects S Corp. Basis Step-Up for COD Income in *Nelson*," 88 J. Tax'n 272 (May 1998); Lockhart and Duffy, "Tax Court

turn, did not defend the Tax Court's holding in this regard on appeal.

When the Tenth Circuit reviewed the Tax Court decision, it found the Tax Court's interpretation of § 108(d)(7)(A) unpersuasive, discerning "no intent by Congress to treat certain subchapter S corporation income at the corporate level, while treating other income at the shareholder level." 182 F.3d at 1148. The Tenth Circuit held that such income would pass through to shareholders unless it was absorbed in the attribute reduction required by § 108(b). 182 F.3d at 1148. The Third Circuit in *Farley*, Op. at 14, and the Seventh Circuit in *Witzel*, 2000 WL 30084 at *2-*3, similarly reasoned that excluded COD income constituted an "item of income" for purposes of the § 1366 pass through.

C. The Tenth Circuit's Holding That Discharge Of Indebtedness Income Is Offset By Attribute Reduction Is Contrary To The Plain Language Of The Statutes, Which Require That Attribute Reduction Occur Following The Year Of Discharge, And Is In Conflict With The Third Circuit's Holding In *Farley v. United States*, ___ F.3d ___ (3d Cir. 2000).

The Tenth Circuit concluded that an S corporation's COD income does not pass through to shareholders and increase their stock basis because it is eliminated at the S corporation level as a result of its being "applied against"

Rules in Nelson that S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis," 25 Wm. Mitchell L. Rev. 287 (1999).

shareholder suspended losses, which are treated as a "tax attribute" and subject to reduction under § 108(b). However, in order to reach this result, the Tenth Circuit had to take a position squarely at odds with the timing rules for when income is realized, the tax consequences of the realization, and rules governing the timing of attribute reduction.

The Tenth Circuit considered the matter a close question and acknowledged that, if corporate attributes were reduced after the taxable year of the discharge, "the taxpayers' theory must prevail." 182 F.3d at 1148. The Tenth Circuit examined the timing statute, § 108(b)(4)(A), and interpreted that statute to provide that attribute reduction occurs during, rather than after, the taxable year of discharge and prior to the required passthrough of all items of S corporation income. However, in its construction of § 108(b)(4)(A), the Tenth Circuit disregarded:

(1) The plain language of the statute, which requires that attribute reduction "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." § 108(b)(4)(A);

(2) Section 1017 of the Code, which expressly requires that property basis, one of the attributes subject to reduction, be reduced after the year of discharge; and

(3) The rules of §§ 108(d)(7)(B) and 1366(d)(1), which require that all items of S corporation income for the year be taken into account at the shareholder level before the amount of the "suspended loss" attribute can be determined.

1. The decision of the Tenth Circuit conflicts with the plain language of 26 U.S.C. § 108(b)(4)(A) and the Third Circuit's opinion in *Farley v. United States*, ___ F.3d ___ (3d Cir. 2000).

Section 108(b)(4)(A) provides that the tax attribute reduction required by § 108(b)(2) "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." This means that any tax attributes that may factor into the determination of tax for the taxable year of the discharge may be used for that purpose. It is only those attributes, if any, left over after the tax computation that are subject to reduction.

Congress understood that attribute reduction was to be postponed until after the full computation of the current year's tax liability. The Senate Report explained that § 108(b) provides that both the current year's loss and any NOL carryover to that year are potentially subject to reduction by excluded COD income, but added that "[t]hese reductions are made after the computation of the current year's tax period." S. Rep. No. 96-1035, 96th Cong., 2d Sess. 13 (1980), 1980-2 C.B. 620, 626 n.13.

The Third Circuit in *Farley v. United States* noted that the *Gitlitz* court had concluded that the timing rule of § 108(b)(4)(A) was dispositive of the case. The *Farley* court agreed. Op. at 12, App. at 107. However, the *Farley* court saw no statutory support for the *Gitlitz* court's conclusion that § 108(b)(4)(A) was limited in its application to the computation of certain tax applications, such as limitations on deductions, charitable contribution limits, and alternative minimum tax, and did not require

the determination of the taxpayer's ultimate tax liability before attributes were reduced. *Farley*, Op. at 12 n.4, App. 108-109.

Indeed, the *Gitlitz* court's attempted limitation of § 108(b)(4)(A) to "certain tax applications," such as charitable contribution limits, creates a rule that cannot be reconciled with the language of the statutes. Under § 170, an individual taxpayer's charitable contribution deduction is limited to a percentage of his adjusted gross income (AGI), without considering NOL carrybacks from subsequent years. § 170(b)(1)(F). AGI, however, includes NOL carryforwards from prior years. A taxpayer with an NOL carryforward of $100 and $100 of excluded COD income, who makes a charitable contribution must compute his or her AGI for purposes of determining the allowable charitable contribution amount. Under the *Gitlitz* court's interpretation of § 108(b)(4)(A), the taxpayer would first include the NOL carryforward because COD income would not be applied to "eliminate" the NOL for purposes of calculation of the charitable deduction. This low AGI would serve to limit the charitable contribution deduction for the year, but then the taxpayer would have to make a second computation to determine his ultimate tax liability for the year. In that computation, the taxpayer could not use his $100 NOL because it was a tax attribute subject to reduction. The taxpayer would therefore pay twice for the COD income exclusion: the charitable contribution deduction would be limited as if there were an NOL lowering his AGI, yet his or her ultimate tax liability would be calculated without the NOL attribute.

We submit that § 108(b)(4)(A) cannot be interpreted as requiring certain initial computations that are part and

parcel of the calculation of tax liability for the year be made by taking tax attributes into account, while the final computation is made without them. The statute provides no hint that such a result is intended, nor any principled way of differentiating those computations that include tax attributes from those that do not.

The *Farley* court held that the plain language of the statute mandated the following result:

> The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward. . . . Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholder's S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).
>
> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable

> year of the discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1).

Farley, Op. at 13-14, App. at 109-110.[7]

Other courts that have considered this issue have uniformly held that attribute reduction is not made until after the tax liability for the year is computed. In *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 103 T.C. 398 (1994), *aff'd per curiam, adopting the opinion of the Tax Court*, 62 F.3d 136 (5th Cir. 1995), the Tax Court (and the Fifth Circuit by adoption) considered the application of the attribute reduction rules in the consolidated return setting, and held that tax attribute reduction under § 108(b)(4) does not occur "until the next taxable year." 103 T.C. at 414-415.

The Tenth Circuit's opinion is also contrary to the Tax Court's holding in *Kahle v. Commissioner*, T.C.M. (RIA) 97,091. There, in considering the case of a bankruptcy estate which had come into possession of an individual taxpayer's tax attributes under § 1398, Judge Tannenwald held that, under § 108(b)(4), the taxpayer/bankrupt estate "may use the tax attributes to determine its tax liability for the year of discharge, after which the tax attributes

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[7] The Seventh Circuit in *Witzel* held that § 108 attribute reduction eliminated the suspended losses, but failed to acknowledge the existence of the § 108(b)(4)(A) timing rule.

are reduced by the estate under section 108(b)(2) before being returned to the debtor/taxpayer."

The sole authority cited by the Tenth Circuit in support of its conclusion is a treatise, C. Richard McQueen and Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice § 25:6, at 25-6 (3d ed. 1997). In a discussion of § 1398 (which coordinates the transfer of tax attributes between individual taxpayers in Chapter 11 and their bankruptcy estates), the treatise states, without analysis, that § 108(b)(4) provides "that tax attribute reduction must be made for the taxable year of the discharge."[8] Not only is this statement contrary to the conclusion reached by the authors of the more highly regarded Collier on Bankruptcy Taxation, *see* 15 Collier on Bankruptcy ¶ 6.03[4][b][i], at 6-103 (Lawrence P. King ed., 15th ed. 1999), but it is contrary as well to the conclusions of every other commentator to consider the issue.[9]

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[8] The thrust of the discussion relates to the question of which entity, the taxpayer or the bankruptcy estate, is responsible for filing the Form 982, listing which attributes retained after the computation of tax are subject to reduction. This form quite logically must be filed with respect to the year of discharge.

[9] A representative sampling of the overwhelming majority of commentators who have reached this conclusion includes Witt, "Report of the [ABA] Section 108 Real Estate and Partnership Task Force," 46 Tax Law. 209, 234 (1992); Hebenstreit, "Tying Together the Tax and Bankruptcy Codes," 54 Ohio St. L.J. 859, 889 n. 21 (1993); and Tax Management Portfolio 731: S Corporation Operations, § III.B.1.a at note 414.2 (1999).

2. The Tenth Circuit's holding places the timing rules for attribute reduction under 26 U.S.C. § 108(b)(4)(A) in conflict with the timing rules for attribute reduction under 26 U.S.C. § 1017.

Section 1017 is another part of the insolvency taxation regime, and it governs the treatment of one of the tax attributes listed in § 108(b)(2): basis in assets. Section 1017(a) specifically provides that, if the taxpayer has COD income and § 108(b)(2)(E) requires a reduction in the taxpayer's basis in property as part of the attribute reduction process, then the amount of COD income applied against basis "shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs." Thus, under § 1017, where the taxpayer sells an asset with a $100 basis in the year of discharge for $100 and has $100 COD income, the asset basis will not be reduced by the COD income in determining the taxpayer's gain and tax liability for the year of the discharge. However, if the taxpayer instead sold the asset in the year after the discharge, his basis would have been lower, producing gain recognition and tax liability in that year.[10]

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[10] Section 108(b)(5) allows taxpayers to elect to have reduction in asset basis under §§ 108(b)(2)(E) and 1017 occur in lieu of other attribute reduction. Under § 1017, such reduction takes place the first day of the following year. The Tenth Circuit's reasoning, which generally would require attribute reduction in the year of discharge, offsetting the basis increase for COD income, would allow taxpayers with both basis in assets and suspended losses to elect, under § 108(b)(5), to have

Section 1017 was amended as part of the Bankruptcy Tax Act of 1980 (94 Stat. 3389), as was § 108. Prior to amendment in 1980, § 108 provided a much more limited exclusion for COD income, specifically conditioned upon the taxpayer's affirmative election to reduce his basis in accordance with § 1017. § 108 (1979), amended by 94 Stat. 3389 (1980). The pre-1980 version of § 1017 provided that where COD income was excluded under § 108, the taxpayer's basis in property owned at the beginning of or at any time during the taxable year of the discharge would be reduced "as of the first day of the taxable year in which the discharge occurred." § 1017 (1979), amended by 94 Stat. 3389 (1980). New §§ 108 and 1017 provide additional relief to insolvent and bankrupt taxpayers. That is, § 108(b)(4)(A) permits insolvent taxpayers who have COD income to determine their tax liability for the year of the discharge before making any attribute reduction. The timing rules of § 1017 were likewise amended so as to be consistent with new § 108(b)(4)(A), and to provide that, in the case of basis in assets, just as with all other attributes listed under § 108(b)(2), attribute reduction occurs after the year of discharge, i.e., at the beginning of the next succeeding taxable year.

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some or all of the attribute reduction (basis reduction) happen in a different year from the §§ 1366 and 1367 passthrough. This would mean that, where taxpayers made the § 108(b)(5) election, excluded COD income would be added to stock basis in the year of the discharge and would not be "absorbed" in the attribute reduction process, because attribute reduction with respect to basis in property would not occur until the following year. Such electing taxpayers would be allowed a basis increase and be permitted to make use of suspended losses during the year of the discharge, unlike their non-electing counterparts.

Rather than achieving a better interpretation of the Code, the Tenth Circuit's opinion artificially and inappropriately frustrates Congress's intention and bifurcates attribute reduction into two separate years: the year of the discharge for some attributes and the following year for basis in property. This is a perverse and indefensible result.

3. The Tenth Circuit disregarded the express language of 26 U.S.C. §§ 108(d)(7)(B) and 1366(d)(1) when it concluded that suspended losses become corporate net operating losses subject to attribute reduction before being passed through and taken into account by shareholders in the determination of their tax liability.

In explaining how it understood COD income to be "absorbed" in the attribute reduction process, the Tenth Circuit misinterpreted the relevant statutes. The Tenth Circuit stated that the corporation "first must compute its discharge of indebtedness income and set this figure aside temporarily." 182 F.3d at 1151. Then, the Tenth Circuit held that § 108(d)(7)(B) requires that shareholder suspended losses "be added to the corporation's annual net operating losses in applying the net operating loss attribute reduction." 182 F.3d at 1148. The Tenth Circuit concluded that this means that before the Taxpayers compute their stock basis, (1) the corporation must compute its NOL attribute, which equals the suspended losses of the Taxpayers from prior years, plus their current (1991) loss and (2) the corporation must then apply the COD income against the suspended losses, eliminating the

COD income for passthrough purposes. 182 F.3d at 1151.[11]

The Tenth Circuit did not recognize that the computations required by step (1) presuppose passthrough of COD income before step (2). Section 108(d)(7)(B) treats "any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1)," as an attribute subject to reduction under § 108(b). Thus, the taxpayer must first make a determination as to how much loss or deduction is "allowed" and how much "disallowed" for the taxable year, pursuant to § 1366(d)(1). Section 1366(d)(1) provides that the disallowed amount is determined with reference to the shareholders' adjusted basis in their stock "determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year."

Therefore, Taxpayers must first determine their stock basis under § 1367(a), taking into account all items of income for the year, including COD income, as well as all items of loss or deduction (which include previously suspended losses from prior years under § 1366(d)(2)) in order to determine the net suspended loss for the year under § 1366(d)(1). Analytically, this calculation of basis under § 1367 must be made prior to the time such suspended loss for the year comes into existence pursuant to

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[11] The Seventh Circuit in *Witzel* disagreed with the Tenth Circuit's opinion in *Gitlitz* in this regard, reasoning that statutory attribute reduction did not prevent the §§ 1366 and 1367 passthrough of income and basis increase. 2000 WL 30084, at *2-*3. Basis would then be available to absorb future year losses, or to be taken into account at disposition.

§ 1366(d)(1) and becomes an "attribute" subject to reduction pursuant to § 108(d)(7)(B). Only that amount of loss, if any, which exceeds the shareholder's share of all corporate income for the year, including excluded COD income, is actually "disallowed for the taxable year of the discharge" under § 1366(d)(1) and subject to attribute reduction. Thus, it is a violation of the statutory schema to "temporarily set aside" the COD income and calculate suspended losses for the year; the COD income must be taken into account in computing the disallowed losses at the shareholder level under §§ 108(d)(7)(B) and § 1366(d)(1).

D. The Tenth Circuit's Opinion Conflicts With The Standards Of Statutory Interpretation Established By This Court.

The real reason that the Tenth Circuit and the Tax Court held for the IRS in *Gitlitz* was not that the statutory language compelled the position advanced by the Commissioner, but rather because the courts perceived the Taxpayers' position would result in a "windfall." This perception is unfounded.[12] The Taxpayers merely seek equal treatment with other insolvent taxpayers. In its opposition to Petitioners' Petition for Rehearing in the

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[12] The *Farley* court noted the government had presented scant evidence that following the statutory language would provide the taxpayers with benefits not intended. Op. at 14-15, App. at 110-112. Moreover, the *Farley* court reasoned that in cases where an S corporation had basis in property in excess of encumbrances on that property equal to or greater than the amount of the discharge, there would not be even the possibility of an unwarranted benefit. Op. at 17, App. at 114.

Tenth Circuit, the Commissioner publicly disavowed any intention of applying the timing rule adopted by the *Gitlitz* court to any attribute other than suspended losses. Response to Appellants' Petition for Rehearing, pp. 5-7. The Commissioner apparently agrees that other insolvent taxpayers receive the full benefit of the exclusion of income, as well as the full use of any tax attributes to reduce tax liability during the year of the discharge. Suspended losses are governed by the same timing rules applicable to all other tax attributes, and should be available to reduce tax liability, but only in the year of the discharge. The language of § 108(b)(4)(A) applies equally to all attributes; there is no way to parse the language of § 108(b)(4)(A) to provide for the reduction of certain disfavored attributes in the year of the discharge, but other more favored attributes in the subsequent year.

The opinion in *Gitlitz* in effect treats excluded COD income just as if it were fully taxable income and not subject to an exclusion under § 108. If the COD income had been taxable income, Taxpayers would have increased their basis by the amount of the COD income. The suspended losses would then have been freed up, offsetting the taxable income and reducing the Taxpayer's basis under § 1367(a)(2)(B). This is exactly the same position as the *Gitlitz* opinion places Taxpayers, who were supposed to receive the benefit of an exclusion from tax. To avoid a perceived "windfall," the Tenth Circuit has unfairly denied any benefit flowing from the § 108(a) exclusion; it might as well have been taxable income.

This is a case where the cure is worse than the disease. The federal courts do not have the authority to revise and distort the Code in order to reach what the

Commissioner portrays as better tax policy. *See Abdalla v. Commissioner*, 647 F.2d 487, 503 (5th Cir. 1981); *International Trading Company v. Commissioner*, 484 F.2d 707, 711 (7th Cir. 1973). In *Transco Exploration Co. v. Commissioner*, 949 F.2d 837, 841 (5th Cir. 1992), the court clearly articulated this Court's longstanding requirement that courts construe the Code as written:

> Indeed, the Supreme Court stated in *Hanover* [*Hanover Bank v. Commissioner*, 369 U.S. 672 (1962)] that 'we are not at liberty, not withstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of a statute.' 369 U.S. at 387, 82 S.Ct. at 1089. Similarly, the Court has explained that 'where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.' *Lewyt Corp. v. Commissioner of Internal Revenue*, 349 U.S. 237, 240, 75 S.Ct. 736, 739, 99 L.Ed. 1029 (1955). Therefore, although we should try to avoid double tax benefits, courts must leave them standing if the code positively requires this outcome.

Nothing in the language of the statutes relating to the passthrough of income and the calculation of basis or the statute relating to the exclusion of COD income even remotely suggests that taxpayers cannot increase their stock basis by COD income and deduct losses prior to engaging in attribute reduction.

Perhaps the best evidence of the absence of statutory support for the Commissioner's position is the history of

this litigation. Initially, in the Tax Court, the Commissioner argued that COD income is not "tax exempt," then later that COD income is not "realized." The Tax Court rejected the "no realization" position, but reversed itself, relying upon the "applied at the corporate level" language of § 108(d)(7)(A) to hold that losses are never passed through to shareholders. In litigation before the Tenth Circuit, the Commissioner abandoned that argument altogether and, without citing any authority, urged that the pass through doesn't take place because COD income is "temporarily set aside" and then eliminated in the attribute reduction process. Appellee Brief at 28. The Tenth Circuit adopted a variant of the government's position, believing that it had found the statutory anchor missing from the government's position in § 108(b)(4)(A).

The interpretation of the Code, however, should not be a moving target, requiring taxpayers to overcome an endless stream of successive arguments based upon what the Commissioner or the courts believe should be the law. It should be based upon the language of the statutes as written.

VIII. CONCLUSION

This Court should grant a writ of certiorari to resolve the conflict between the decisions in *Gitlitz* and *Witzel* and those in *Farley*, *CSI*, and *Hogue*.

RESPECTFULLY SUBMITTED this 1st day of February, 2000.

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PUBLISH

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

DAVID A. GITLITZ; LOUISE A. GITLITZ, Petitioners-Appellants, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee. and PHILIP D. WINN; ELEANOR G. WINN, Petitioners-Appellants, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	No. 98-9009 No. 98-9010

APPEALS FROM UNITED STATES TAX COURT
(T.C. Nos. 5358-96 & 5359-96)

(Filed July 6, 1999)

Darrell D. Hallett (John M. Colvin with him on the brief), Chicoine & Hallett, P.S., Seattle, Washington, for the appellants.

Edward T. Perelmuter (Loretta C. Argrett, Assistant Attorney General, and Teresa E. McLaughlin with him on the brief), of the Tax Division, Department of Justice, Washington, D.C., for the appellee.

Before **TACHA, MAGILL,*** and **BRISCOE,** Circuit Judges.

BRISCOE, Circuit Judge.

The Commissioner of Internal Revenue assessed tax deficiencies against David and Louise Gitlitz and Philip and Eleanor Winn after determining the taxpayers improperly utilized excluded discharge of indebtedness income to adjust their subchapter S corporate bases. The United States Tax Court upheld the Commissioner's deficiency determinations and taxpayers now appeal. We exercise jurisdiction pursuant to 26 U.S.C. § 7482(a)(1) and affirm.

I.

David Gitlitz and Philip Winn each owned a fifty-percent interest in PDW & A, Inc., a Colorado corporation that elected to be taxed under subchapter S of the Internal

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* Honorable Frank J. Magill, Senior Circuit Judge, United States Court of Appeals for the Eighth Circuit, sitting by designation.

Revenue Code. PDW & A was a partner in Parker Properties Joint Venture, a real estate partnership. In 1991, Parker Properties realized $4,154,891 in discharge of indebtedness income; PDW & A's pro rata share was $2,021,296. At that time, PDW & A was insolvent to the extent of $2,181,748 and thus was excluded from tax liability for the discharged debt income. *See* 26 U.S.C. §§ 108(a)(1)(B), 108(d)(6).[1]

Entering the 1991 tax year, both Gitlitz and Winn had suspended (i.e., unused) losses because each lacked sufficient basis in PDW & A to deduct losses in prior years. *See* 26 U.S.C. § 1366(d)(1)(A) (the "aggregate amount of losses and deductions taken into account by a shareholder under [§ 1366(a)] for any taxable year shall not exceed . . . the adjusted basis of the shareholder's stock in the S corporation"); 26 U.S.C. § 1366(d)(2) ("Any loss or deduction which is disallowed for any taxable year by reason of [§ 1366(d)(1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder."). In 1991, Gitlitz and Winn each had additional losses from their association with PDW & A (i.e., pro rata shares of PDW & A's 1991 operating losses) which, when combined with their suspended losses, totaled $1,010,648.[2] Absent an increase in basis, Gitlitz

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[1] With partnerships such as Parker Properties, the insolvency-based discharge of indebtedness income exclusion is assessed at the *partner* level. *See* 26 U.S.C. § 108(d)(6).

[2] Gitlitz had $538,423 in 1991 pro rata losses and $472,225 in suspended losses from previous tax years. Although the record does not reflect how Winn's losses were broken down, it appears he used a calculation similar to that used by Gitlitz.

and Winn would have had to treat these losses as suspended losses under § 1366(d)(1) because their bases in the corporation would have remained insufficient to permit contemporaneous recognition.

On their respective joint income tax returns for the relevant tax years, Gitlitz and Winn claimed increases in the bases of their PDW & A stock in the amount of their pro rata shares of the excluded discharge of indebtedness income.[3] Gitlitz and Winn maintained the excluded discharged debt was an "item of income (including tax exempt income)," as that term is used in § 1366(a)(1)(A), thereby facilitating their basis increases pursuant to 26 U.S.C. § 1367(a)(1)(A). With the basis adjustments, the validity of which is at issue here, Gitlitz and Winn were able to claim the full amount of their pro rata share of PDW & A's ordinary losses.

The Commissioner determined the taxpayers could not use PDW & A's excluded discharge of indebtedness income to increase their bases in the corporation stock and denied the taxpayers' ordinary loss deductions. The taxpayers contested the deficiency determinations. The Tax Court initially issued a consolidated opinion in favor of the taxpayers, but later granted the Commissioner's motion for reconsideration. The court relied on its "reviewed decision" in *Nelson v. Commissioner*, 110 T.C. 114 (1998), and upheld the Commissioner's deficiency

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[3] Gitlitz reflected the adjusted basis on his 1991 return and Winn reflected the adjustment on his 1992 return. Winn did not employ a basis adjustment to facilitate an ordinary loss deduction on his 1991 joint tax return because he believed passive activity loss limitations prevented him from doing so.

determinations, determining discharge of indebtedness income, which is excluded from gross income under § 108(a), does not pass through to shareholders of subchapter S corporations. Thus, the court concluded a subchapter S corporation's shareholder may not use the corporation's untaxed discharge of indebtedness income to increase the shareholder's adjusted basis of corporate stock.

II.

Decisions of the United States Tax Court are reviewed "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." 26 U.S.C. § 7482(a)(1). We review factual findings for clear error and legal conclusions de novo. *Schelble v. Commissioner,* 130 F.3d 1388, 1391 (10th Cir. 1997). Because the only issue here is whether the law applied to the undisputed facts satisfies the relevant statutory standard, we review the Tax Court's decision de novo as we are equally competent to draw conclusions from undisputed facts. *Id.* (citing *Anderson v. Commissioner,* 62 F.3d 1266, 1270 (10th Cir. 1995)).

III.

Before reaching the merits of taxpayers' arguments, we address their contention that the Commissioner waived in the Tax Court many of the arguments now asserted on appeal. The Commissioner made clear in its motion for reconsideration that, notwithstanding certain ambiguous comments of counsel during the summary

judgment hearing, it did not intend to waive any arguments previously asserted in its summary judgment motion. The Tax court apparently accepted the Commissioner's clarification in the order granting reconsideration. Such a decision is committed to the lower court's sound discretion, *see Elsken v. Network Multi-Family Sec. Corp.*, 49 F.3d 1470, 1476 (10th Cir. 1995), and we discern no abuse here. Further, "it is well-settled that a court is not bound by stipulations of the parties as to questions of law." *Koch v. United States*, 47 F.3d 1015, 1018 (10th Cir. 1995) (citations and internal alterations omitted). "[O]ur analysis, which may rest on any grounds for which there is a record sufficient to permit conclusions of law, even grounds not relied on by the district court, is not constrained by the government's ill-considered concession." *United States v. Furman*, 112 F.3d 435, 438 n.2 (10th Cir. 1997) (citations omitted).

Subchapter S Corporations

Subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361-1379, permits certain corporations to elect to be taxed in a similar, but not identical, fashion as partnerships. *See* 3 Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 95.6.1 (2d ed. 1991) (highlighting major distinctions). A subchapter S corporation generally does not pay taxes as an entity. 26 U.S.C. § 1363(a). Instead, the corporation's profits and losses pass through directly to its shareholders on a pro rata basis and are then reported on the shareholders' individual tax returns. 26 U.S.C. § 1366(a). This conduit approach allows shareholders to avoid double taxation on corporate earnings. Tax integrity, meanwhile, is preserved by

requiring shareholders to treat all income and deductions as if "realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." 26 U.S.C. § 1366(b). In other words, "the items attain no greater dignity from being passed through the corporation." Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 6.06[2][c] (6th ed.1998).

To further prevent double taxation of subchapter S corporate income upon distribution to shareholders, § 1367(a) normally requires shareholders to adjust their corporate bases by the items identified in § 1366(a). In particular, basis must be increased by, *inter alia*, the items of income delineated in § 1366(a)(1)(A). Basis must be decreased by, *inter alia*, the items of loss and deduction set forth in § 1366(a)(1)(A), as well as corporate distributions previously excluded from shareholders' income pursuant to 26 U.S.C. § 1368(b). Section 1368(b) provides that distributions of a subchapter § corporation having no earnings and profits (as is the case with PDW & A) are treated as follows:

> (1) *Amount applied against basis.* – The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.
>
> (2) *Amount in excess of basis.* – If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

Two examples help explain how this statutory scheme operates. Assume the sole shareholder of a subchapter S corporation has a basis of $100 in the corporation's stock. The corporation realizes $200 in taxable income. At the end of the tax year, the shareholder pays tax on the $200 of income under the "pass through" principles described above. The corporation distributes the $200 to the shareholder the following year. In the absence of an upward basis adjustment, the shareholder would be liable for additional tax upon the distribution pursuant to § 1368(b)(2) because the amount of the distribution ($200) exceeds his preexisting basis in the stock. Sections 1366 and 1367 prevent this double taxation by mandating a $200 basis increase when the corporation first realizes the income and a $200 basis decrease upon the corporation's distribution of the income.

A second example illustrates how the character of tax-exempt income is preserved under the subchapter S framework. Assume the same subchapter S corporation realizes $200 in tax-exempt income. Although a "pass through" technically occurs, the shareholder pays no tax on the income because, under § 1366(b), the income after "pass through" has the same character as if it was realized by the corporation. The corporation distributes the income to its shareholder the next year. Without the requisite basis adjustment, the shareholder would be forced to pay tax on the distribution under § 1368(b)(2) because the amount of the distribution exceeds his preexisting basis in the stock. Once again, §§ 1366 and 1367 prevent such a result by dictating a $200 basis increase when the corporation first realizes the income and a $200 basis decrease upon the corporation's distribution of the

income. As a result, the shareholder pays no taxes on the income.

Discharge of Indebtedness Income and Insolvency Exception

Section 61(a)(12) of the Internal Revenue Code, 26 U.S.C. § 61(a)(12), ordinarily requires a taxpayer who has incurred a financial obligation, which is later discharged in whole or in part, to recognize as taxable income the extent of the reduction in the obligation. Section 108(a)(1) provides an exception to this rule if, *inter alia*, the debt is discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent. Exclusion of discharge of indebtedness from gross income, however, does not come without a price. Specifically, a taxpayer omitting such discharged debt from his income must make correlative reductions in various "tax attributes" that could otherwise yield future tax benefits. *See* 26 U.S.C. § 108(b). After the requisite tax attribute reductions have been made, any "remaining debt discharge amount is disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 96-1035, at 2 (1980), *reprinted* in 1980 U.S.C.C.A.N. 7017, 7018. This statutory scheme has "the effect of relieving the taxpayer of immediate recognition of debt discharge income, but at the cost of a forfeiture of an equal amount of potential tax benefit." 1 Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.3, at 7-58 (3d ed.1999).[4]

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[4] If a taxpayer's attributes are insufficient to absorb all of his cancellation of indebtedness income, § 108 effectively provides a permanent exemption from taxation on that income.

In this case of first impression, taxpayers maintain PDW & A's canceled debt is an "item of income (including tax exempt income)" under § 1366(a)(1)(A). As the taxpayers see it, PDW & A's debt discharge, because it is an item of income under § 1366(a)(1)(A), passes through to them immediately by way of § 1366 and allows them to increase their basis in the corporation pursuant to § 1367(a)(1)(A). If we embrace taxpayers' position, subchapter S corporate shareholders would receive a windfall. Not only would shareholders avoid taxation on the corporation's discharged debt, they would also receive an upward basis adjustment, thereby permitting them to report a larger capital loss from the sale of their stock. In addition, shareholders would be able to use the corporation's net operating losses to reduce their own non-corporate related gross income without having to decrease the net operating losses by the amount of the corporation's discharged debt. Taxpayers acknowledge the windfall, but insist the statutory language dictates such a result.

The Supreme Court has held the Internal Revenue Code "should not be interpreted to allow [taxpayers] the practical equivalent of [a] double deduction absent a clear declaration of intent by Congress." *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (citations omitted). We believe this principle is equally applicable to windfalls. Accordingly, only if taxpayers' theory is unequivocally supported by the statutory text may we adopt it here. Although taxpayers make some compelling arguments, we do not believe Congress intended to confer such a windfall upon individuals in their position.

Exclusion of Discharge of Indebtedness Income at Corporate Level

With subchapter S corporations, § 108's discharge of indebtedness income exclusions *and* tax attribute reduction principles must be applied at the *corporate* level. 26 U.S.C. § 108(d)(7)(A). The Commissioner argues, and the Tax Court held, this rule serves as an exception to the normal pass-through practice in which items of income percolate directly to a corporation's shareholders. Taxpayers claim, however, that the only purpose of § 108(d)(7)(A) is to create uniformity in the tax treatment of subchapter S corporations by applying the insolvency test at the corporate rather than shareholder level. If the corporation is solvent, the debt discharge is taxable; if the corporation is insolvent, the canceled debt is excluded from gross income up to the amount of the corporation's insolvency. Under either scenario, the taxpayers insist, the pass-through principles of subchapter S are fully applicable and shareholders must adjust their bases in the corporation. Although taxpayers' argument is not without merit, we reject it in favor of a position closer, although not identical, to that of the Commissioner.

We note preliminarily that the parties have devoted significant discussion to the legislative history of the Subchapter S Revision Act of 1982, Pub.L. No. 97-354, 96 Stat. 1669, which adopted 26 U.S.C. §§ 1366-1368, and the Tax Reform Act of 1984, Pub.L. No. 98-369, 98 Stat. 494, which amended 26 U.S.C. § 1366. We find this legislative history largely unhelpful. The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the

corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that *all* items of income are attributed initially to the corporation. Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.

The outcome of this case is ultimately determined by the timing of the pass-through. If the attribute reduction procedures *precede* the pass-through, the corporation's excluded discharge of indebtedness income is absorbed before it can pass through to shareholders and compel basis adjustments. Potential windfalls are thus avoided. If, on the other hand, attribute reduction takes place *after* the pass-through, the taxpayers' theory must prevail. For the reasons described below, we conclude attribute reduction must precede the pass-through.

Shareholder Suspended Losses as Corporate Net Operating Losses

Section 108(d)(7)(B) provides that, in administering the tax attribute reduction scheme, shareholder losses suspended pursuant to § 1366(d)(1) must be treated as net operating losses for purposes of § 108(b)(2)(A), thereby precluding subchapter S corporation shareholders with carryover losses from enjoying the tax benefits of ordinary losses while simultaneously avoiding taxation on discharge of indebtedness income. As we interpret this statute, these suspended losses are added to the corporation's annual net operating losses in applying the net operating loss tax attribute reduction.

Taxpayers maintain subchapter S corporations, by their very nature, have no net operating losses, and suggest the net operating loss tax attribute is confined to shareholder suspended losses. We have found no case law squarely addressing this issue. It is true that, because a subchapter S corporation's losses are normally deductible only by its shareholders and only to the extent of their bases in the corporation, *see* § 1366(d)(1), the corporation itself is not permitted to take a net operating loss deduction. However, nothing in the Internal Revenue Code mandates that corporate net operating losses pass through *immediately* to shareholders. If pass through was immediate, shareholders could secure a windfall by (1) avoiding tax on corporate discharge of indebtedness income under § 108(a), and (2) employing the corporation's passed-through net operating losses to reduce their own non-corporate related gross income without having first decreased the net operating losses by the amount of the corporation's discharged debt. The inequity would be magnified further if the shareholder's pre-pass-through basis was insufficient to recognize the net operating losses, and recognition was only possible as a result of the discharged debt increasing the shareholder's basis. Moreover, regardless of the pre-pass-through basis, the increase in basis resulting from an immediate pass-through of nontaxable discharge of indebtedness income would permit shareholders to secure a higher capital loss upon the ultimate disposition of the corporation.

To embrace the taxpayers' position is to effectively eliminate the "price" Congress imposed upon entities whose discharged debt income is excluded under § 108. We conclude when § 108(a)'s discharge of indebtedness

income exclusion is triggered, a shareholder's pro rata share of the corporation's net operating losses passes through to him only to the extent such losses are not absorbed by the shareholder's pro rata share of the excluded canceled debt.[5]

26 U.S.C. § 108(b)(4)(A)

The most difficult aspect of this case is determining the role § 108(b)(4)(A) plays in the tax calculation. This section states the attribute reductions outlined in § 108(b)(2) "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." Taxpayers suggest an insolvent subchapter S corporation's discharge of indebtedness may be used in the current tax year to increase shareholder basis because the requisite tax attribute reduction does not occur until the following year. In essence, they claim the corporation's excluded discharge of indebtedness income passes through to them immediately upon recognition by the corporation.

Unfortunately, there is no case law and commentators are divided on the proper operational mechanics of

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[5] Although not applicable to this case, the Internal Revenue Service recently proposed regulations providing that excluded discharge of indebtedness income may never be treated as tax-exempt income under § 1366(a)(1)(A), and is thus not susceptible to a pass-through, because the excluded income is generally only deferred, and not permanently exempted. *See* 63 Fed.Reg. 44181, 44182-44183 (1998) (discussing rationale for proposed Treas. Reg. § 1.1366-1(a)(2)(viii)). We do not address the validity of this proposed regulation.

§ 108(b)(4)(A). *Compare* C. Richard McQueen and Jack F. Williams, *Tax Aspects of Bankruptcy Law and Practice* § 25:6, at 25-6 (3d ed.1997) (tax attribute reductions made in year of discharge) *with* 15 *Collier on Bankruptcy* ¶ 6.03[4][b][i], at 6-103 (Lawrence P. King ed., 15th ed.1999) (tax attribute reductions made in year following discharge). The only point upon which all agree is that § 108(b)(4)(A) is not an example of legislative clarity. Although a close question, we ultimately conclude the taxpayers' theory is not compelling. According to § 108(d)(7)(A), tax attributes reductions must be applied at the corporate level with subchapter S corporations. Taxpayers' proposal would not give effect to the attribute reduction scheme. Taxpayers' approach, in fact, would thwart the purpose of the net operating loss tax attribute:

> By reason of the debt discharge, losses sustained by the taxpayer have been borne by the taxpayer's creditors. Normally, this would be reflected by requiring that the taxpayer recognize gross income in the year of the discharge to offset its earlier deductions of the shifted losses. However, because the losses have not yet yielded tax benefit, this rule simply shaves down the loss deductions to eliminate the portions not ultimately borne by the taxpayer.

1 Bittker and Lokken, *supra* ¶ 7.6.3, at 7-59.

As we see it, § 108(b)(4)(A) is simply designed to compute certain tax applications (e.g., establishing income ceilings for § 108(b)(2) deductions/credits, assessing charitable contribution deduction limitations, evaluating application of possible alternative minimum tax, etc.) before reducing tax attributes. We do not read the

statute as mandating that attribute reductions be made *in the tax year following the year of the discharge.* We concede that, if § 108(b)(4)(A) is read narrowly and in isolation, it is plausible to conclude Congress intended tax attributes to be reduced only in the tax year following the taxable year of the discharge. But we must read the Internal Revenue Code as a whole. *UNUM Corp. v. United States,* 130 F.3d 501, 507 (1st Cir. 1997). "[T]he expounding of a statutory provision strictly according to the letter without regard to other parts of the Act and legislative history [may] often defeat the object intended to be accomplished." *Id.* (quoting *Helvering v. New York Trust Co.,* 292 U.S. 455, 464 (1934)). Taxpayers' interpretation of § 108(b)(4)(A) would negate the effect of the tax attribution scheme and would give taxpayers an unwarranted windfall.[6]

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[6] The following examples underscore how our interpretation of the interplay between §§ 108 and 1366-1368 operates in practice. In each example, X is the sole shareholder of an insolvent subchapter S corporation.

Example 1: In 1991, the corporation realizes $500 of discharge of indebtedness income and has $100 of net operating losses. The corporation has no other tax attributes and X has no suspended losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily (i.e., it does not pass through immediately to X). The corporation then calculates its net operating losses for the year. Finally, the corporation applies the excluded discharged debt to reduce its tax attributes in accordance with §§ 108(b)(2) and 108(d)(7)(B). After reducing the $500 in discharged debt by the $100 in net operating losses, $400 of canceled debt remains. Because any remaining debt discharge amount is disregarded following the required reduction of tax attributes, this $400 is ignored and has no tax

In 1991, PDW & A realized $2,021,296 in cancellation of indebtedness income. PDW & A was insolvent to the

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consequences. Thus, there are no items of income to pass through to X. X cannot utilize any net operating losses incurred by the corporation to offset his own gross income nor can he adjust his corporate basis.

Example 2: Same facts as example 1, but now the corporation realizes $100 of discharge of indebtedness income and $500 of net operating losses. In calculating its 1991 tax return under the method described above, after reducing the $100 in discharged debt, dollar for dollar, by the net operating losses, $400 of net operating losses remains. The $400 of net operating losses flows through to X and, assuming he has a sufficient basis in the corporation, may be used by him to offset his own gross income.

Example 3: In 1991, the corporation realizes $500 of discharge of indebtedness income and has $100 of net operating losses. The corporation has no other tax attributes. X has $200 in suspended losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily. The corporation then calculates its net operating loss tax attribute ($100 + $200 = $300). Finally, the corporation applies the excluded discharged debt to reduce its tax attributes. After reducing the $500 in discharged debt by the $300 net operating loss tax attribute, $200 of canceled debt remains. Because any remaining debt discharge amount is disregarded following the required tax attribute reductions, this $200 is ignored and has no tax consequences. As a result, there are no items of income to pass through to X. X cannot utilize any net operating losses incurred by the corporation to offset his own gross income nor may he adjust his corporate basis. X has also permanently lost the use of $200 in suspended losses.

Example 4: Same facts as example 3, but now the corporation realizes $100 of discharge of indebtedness income and has $500 of net operating losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily. The corporation

full extent of this figure and thus was excluded from paying taxes on the canceled debt. Shareholders Gitlitz and Winn each had a $1,010,648 pro rata share of discharged debt. Additionally, Gitlitz and Winn each had a combination of pro rata 1991 net operating losses and suspended losses from prior years which totaled $1,010,648. See footnote 2. In calculating its 1991 taxes, PDW & A first must compute its discharge of indebtedness income and set this figure aside temporarily. The corporation then must calculate its net operating loss tax attribute ($1,010,648 for Gitlitz + $1,010,648 for Winn = $2,021,296). Finally, the corporation must apply the excluded discharged debt to reduce its tax attributes. In this case, the net operating loss tax attribute fully absorbs the corporation's excluded discharge of indebtedness income. Thus, there are no items of income to pass through to Gitlitz and Winn. The shareholders cannot utilize any net operating losses incurred by PDW & A to offset their own gross income or to adjust their corporate basis. Further, the suspended losses of Gitlitz and Winn effectively disappear and have no future tax consequences.

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then calculates its net operating loss tax attribute ($500 + $200 = $700). Finally, the corporation applies the excluded discharged debt to reduce its tax attributes. After reducing the $100 in discharged debt, dollar for dollar, by the net operating losses, $400 of 1991 net operating losses remains in addition to X's $200 of suspended losses. The $600 combined amount flows through to X and, depending on his basis, may be used by him (in whole or in part) to offset his own gross income.

Holding Confined to Excluded Discharge of Indebtedness Income

We emphasize this case focuses only on excluded discharge of indebtedness income vis-a-vis insolvent subchapter S corporations. The special exception for treating such excluded income at the corporate level in § 108(d)(7)(A) and the tax attribute reduction scheme in § 108(b) have no application to other forms of tax-exempt income.[7] The distinction is particularly logical when one considers that subchapter S corporation shareholders generally are not entitled to include the corporation's indebtedness to third parties in calculating their basis. *Uri v. Commissioner,* 949 F.2d 371, 373 (10th Cir. 1991). The theory behind this rule is that the shareholders themselves have made no economic outlay. *See Goatcher v. United States,* 944 F.2d 747, 751 (10th Cir. 1991) (citing *Estate of Leavitt v. Commissioner,* 875 F.2d 420, 422 (4th Cir. 1989)). The types of tax-exempt income the taxpayers reference (i.e., non-taxable life insurance proceeds and municipal bond income) are acquired through initial economic outlays.

CSI Hydrostatic Testers

Taxpayers suggest the holding in *CSI Hydrostatic Testers, Inc. v. Commissioner,* 103 T.C. 398 (1994), *aff'd,* 62 F.3d 136 (5th Cir. 1995) (per curiam) is inconsistent with the holding here. *CSI* is unrelated to the present case. The

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[7] We assume here that excluded discharge of indebtedness income is tax-exempt income. As noted earlier, Internal Revenue has proposed regulations that would foreclose such a classification.

issue in *CSI* was whether discharge of indebtedness income, which was excluded from the taxable income of a subsidiary *subchapter C* corporation pursuant to § 108(a), had to be included in the subsidiary's earnings and profits. The case turned on interpretations of 26 U.S.C. § 312(*l*) and 26 C.F.R. § 1.1502-19 (1987). Subchapter S corporations were not at issue. Nor was the potential windfall question before us even considered. In sum, taxpayers' reliance on *CSI* is inapposite. Taxpayers' remaining arguments have been rendered moot by the preceding discussion.

The decision of the Tax Court is AFFIRMED. Taxpayers' motion to supplement the record with a letter which was not a part of the record before the Tax Court is DENIED.

T.C. Memo. 1998-71

UNITED STATES TAX COURT

PHILIP D. AND ELEANOR G. WINN, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent*

DAVID A. AND LOUISE A. GITLITZ, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 5358-96, 5359-96.
Filed February 19, 1998

Darrell D. Hallett, Larry N. Johnson, Robert J. Chicoine, and *John M. Colvin,* for petitioners.

Keith G. Medleau, for respondent.

MEMORANDUM OPINION

COHEN, Chief Judge: In *Winn v. Commissioner,* T.C. Memo. 1997-286, we concluded that respondent's motions for summary judgment should be denied, and petitioners' cross-motions for partial summary judgment should be granted. Thereafter, respondent filed a motion for reconsideration. Released today is the Opinion in *Nelson v. Commissioner,* 110 T.C. ___ (1998), in which the Court decides the same legal issue, to wit, whether discharge of indebtedness income to an S corporation increases a shareholder's basis in the stock of the corporation, in favor of respondent. The arguments discussed in *Nelson* were fully briefed and argued in these cases. Under these

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* This opinion replaces the prior opinion of this Court in these cases, *Winn v. Commissioner,* T.C. Memo. 1997-286, which is hereby withdrawn.

circumstances, respondent's motion for reconsideration will be granted. This Memorandum Opinion replaces T.C. Memo. 1997-286, which is hereby withdrawn.

Background

Respondent determined a deficiency of $242,555 in Philip D. and Eleanor G. Winn's (the Winns) 1992 Federal income tax and a deficiency of $251,192 in David A. and Louise A. Gitlitz's (the Gitlitzes) 1991 Federal income tax. At the time their respective petitions were filed, all petitioners resided in Colorado.

Philip D. Winn (Winn) and David A. Gitlitz (Gitlitz) were shareholders in P.D.W. & A., Inc. (PDW&A), a Colorado corporation. In 1991, PDW&A had an election in effect to be taxed as an S corporation. Effective January 1, 1992, PDW&A revoked its S corporation election.

PDW&A was a partner in Parker Properties Joint Venture (Parker). Parker realized $4,154,891 in discharge of indebtedness income in 1991. PDW&A's distributive share of Parker's discharge of indebtedness income in 1991 was $2,021,296. At the time that Parker realized the discharge of indebtedness income, PDW&A was insolvent to the extent of $2,181,748.

Winn increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge of indebtedness income. Winn did not claim a loss on the Winns' 1991 Federal income tax return because Winn believed that the passive activity loss limitations prevented him from doing so. On the Winns' 1992 Federal

income tax return, Winn claimed losses from PDW&A that were carried over from 1991 totaling $1,010,648.

Gitlitz increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge of indebtedness income. Gitlitz claimed losses from PDW&A totaling $1,010,648 on the Gitlitzes' 1991 Federal income tax return. Absent the basis increase, the deductibility of these losses would have been suspended under section 1366(d), I.R.C.

Respondent disallowed the losses claimed by Winn and Gitlitz on the premise Winn and Gitlitz lacked sufficient basis in their PDW&A stock.

Discussion

Under Rule 121, Tax Court Rules of Practice and Procedure, a summary adjudication may be made "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b), Tax Court Rules of Practice and Procedure. The parties agree that whether discharge of indebtedness income increases a taxpayer's basis in his S corporation stock may be decided as a matter of law.

In *Nelson v. Commissioner*, 110 T.C. ___, filed this date, the Court agreed with respondent that a shareholder of an insolvent S corporation may not increase his or her basis to reflect discharge of indebtedness income to the S

corporation. That Opinion is controlling here. Respondent's motions for summary judgment will be granted, and petitioners' cross-motions for partial summary judgment will be denied.

Appropriate orders will be issued.

T.C. Memo. 1997-286

UNITED STATES TAX COURT

PHILIP D. AND ELEANOR G. WINN, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

DAVID A. AND LOUISE A. GITLITZ, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 5358-96, 5359-96.
Filed June 24, 1997

Darrell D. Hallett, Larry N. Johnson, Robert J. Chicoine, and *John M. Colvin,* for petitioners.

Keith G. Medleau, for respondent.

MEMORANDUM OPINION

COHEN, *Chief Judge*: Respondent determined a deficiency of $242,555 in Philip D. and Eleanor G. Winn's (the Winns) 1992 Federal income tax and a deficiency of $251,192 in David A. and Louise A. Gitlitz's (the Gitlitzes) 1991 Federal income tax. The issue for decision is whether Philip D. Winn (Winn) and David A. Gitlitz (Gitlitz) are entitled to claimed S corporation losses of approximately $1 million, which in turn depends upon whether Winn and Gitlitz may increase their respective adjusted bases in the S corporation stock by their pro rata allocation of discharge of indebtedness income.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

These matters are before the Court on respondent's motions for summary judgment filed January 31, 1997, and on petitioners' cross-motions for partial summary judgment filed March 25, 1997.

Background

At the time their respective petitions were filed, all petitioners resided in Colorado.

Winn and Gitlitz were shareholders in P.D.W. & A., Inc. (PDW&A), a Colorado corporation. In 1991, PDW&A had an election in effect to be taxed as a subchapter S corporation. Effective January 1, 1992, PDW&A revoked its S corporation election.

PDW&A was a partner in Parker Properties Joint Venture (Parker). Parker realized $4,154,891 in discharge of indebtedness income in 1991. PDW&A's distributive share of Parker's discharge of indebtedness income in 1991 was $2,021,296. At the time that Parker realized the discharge of indebtedness income, PDW&A was insolvent to the extent of $2,181,748.

Winn increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge of indebtedness income. Winn did not claim a loss on the Winns' 1991 Federal income tax return because Winn believed that the passive activity loss limitations prevented him from doing so. On the Winns' 1992 Federal income tax return, Winn claimed losses from PDW&A that were carried over from 1991 totaling $1,010,648.

Gitlitz increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge

of indebtedness income. Gitlitz claimed losses from PDW&A totaling $1,010,648 on the Gitlitzes' 1991 Federal income tax return. Absent the basis increase, the deductibility of these losses would have been suspended under section 1366(d).

Respondent disallowed the losses claimed by Winn and Gitlitz on the premise Winn and Gitlitz lacked sufficient basis in their PDW&A stock.

Discussion

Under Rule 121, a summary adjudication may be made "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b). The parties agree that whether discharge of indebtedness income increases a taxpayer's basis in his S corporation stock may be decided as a matter of law.

Section 1367(a)(1) provides:

> (1) Increases in basis. – The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
>
> > (A) the items of income described in subparagraph (A) of section 1366(a)(1),
> >
> > (B) any nonseparately computed income determined under subparagraph (B) of section 1366 (a) (1), and

> (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 1366(a)(1) provides:

> (1) In general. – In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's –
>
> > (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
> >
> > (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702 (a).

The shareholder's basis, once computed, limits the amount of losses and deductions that may be taken into account by a shareholder for the taxable year. Sec. 1366(d).

In memoranda filed with the Court prior to the hearing on these matters, several arguments were set forth in support of respondent's motions, including the argument that discharge of indebtedness income was "deferred" and not "tax-exempt income" under section 1366(a).

(Respondent did not argue that section 1367(b)(1) precluded an increase in basis with respect to income from discharge of indebtedness, presumably because, to the extent at issue here, such income was not required to be included on petitioners' returns.) At the hearing on these matters, however, respondent abandoned those prior arguments and argued the following position:

> If the Court were to hold that excluded COD [cancellation (discharge) of indebtedness] is an item of income under Code section 1366, then you would have to find that it flows through to the taxpayers and they increase their basis. Respondent's position is that it's not an item of income and never flows through * * *

We deal here solely with respondent's "final" position.

Respondent's position is based on section 1.61-12(a), Income Tax Regs., which states in part: "The discharge of indebtedness, in whole or in part, may result in the realization of income", and on section 1.61-12(b), Income Tax Regs., which states in part: "Income is not realized by a taxpayer * * * by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter, the taxpayer's liabilities exceed the value of his assets."

Section 1.61-12(b), Income Tax Regs., adopted by T.D. 6272, 1957-2 C.B. 18, 31, restates the pre-section 108 judicially created insolvency exception. See, e.g., *Estate of Delman v. Commissioner*, 73 T.C. 15, 32 (1979). Section 108 codified the insolvency exception as an exclusion from gross income. Bankruptcy Tax Act of 1980, Pub. L. 96-589, sec. 2, 94 Stat. 3389. Section 108(e)(1) provides that "there shall be no insolvency exception from the general rule

that gross income includes income from the discharge of indebtedness", except as provided in section 108. Thus, section 108, not section 1.61-12(b), Income Tax Regs., controls in these cases.

Respondent would have us treat differently the operation of sections 61(a)(12) and 108 and, for example, sections 61(a)(4) and 103 (relating to interest) or sections 61(a)(10) and 101 (relating to insurance). Respondent argues that, as an illustration, death benefits are first realized under section 61(a)(10) and then certain death benefits are excluded, i.e., not recognized, by section 101. Respondent argues that no such realization occurs in the case of discharge of indebtedness.

Section 61 requires that certain amounts be included in income, i.e., items of income. Specifically, section 61(a)(12) requires that income from discharge of indebtedness be included in gross income. Absent any exclusionary provision, items of income are included in gross income. Sec. 61(a). Sections 101 through 135 exclude specific items of income from gross income. Discharge of indebtedness income to the extent of insolvency is one of the items of income so excluded. Sec. 108 (a) (1) (A), (3).

Based on the foregoing, we hold that discharge of indebtedness is an "item of income" for purposes of determining a shareholder's basis in S corporation stock by its inclusion in the definition of gross income under section 61 (a) (12).

On the basis of the record, respondent's motions for summary judgment will be denied, and petitioners' cross-motions for partial summary judgment will be granted.

To reflect the foregoing,

Appropriate orders will be issued.

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

DAVID A. GITLITZ; LOUISE A. GITLITZ,	)	
Petitioners – Appellants,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	No. 98-9009
Respondent – Appellee.	)	
and	)	
PHILIP D. WINN; ELEANOR G. WINN,	)	
Petitioners – Appellants,	)	No. 98-9010
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent – Appellee.	)	

ORDER

Filed November 3, 1999

Before **TACHA, MAGILL,*** and **BRISCOE**, Circuit Judges.

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* Honorable Frank J. Magill, Senior Circuit Judge, United States Court of Appeals for the Eighth Circuit, sitting by designation.

Appellants' petition for rehearing is denied.

The suggestion for rehearing en banc was transmitted to all of the judges of the court who are in regular active service as required by Fed. R. App. P. 35. As no member of the panel and no judge in regular active service on the court requested that the court be polled, the suggestion is also denied.

Entered for the Court
PATRICK FISHER, Clerk of Court

by: /s/ Illegible
Deputy Clerk

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26 U.S.C. § 108. Income from discharge of indebtedness

(a) Exclusion from gross income

(1) In general

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if –

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness, or

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

(2) Coordination of exclusions

(A) Title 11 exclusion takes precedence

Subparagraphs (B), (C), and (D) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) Insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion Subparagraphs (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.

(3) Insolvency exclusion limited to amount of insolvency

In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) Reduction of tax attributes

(1) In general

The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction

Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL

Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit

Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Minimum tax credit

The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers

Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) Basis reduction

(i) In general

The basis of the property of the taxpayer.

(ii) Cross reference

For provisions for making the reduction described in clause (i) see section 1017.

(F) Passive activity loss and credit carryovers

Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) Foreign tax credit carryovers

Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction

(A) In general

Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction

The reductions described in subparagraphs (B), (C), and (G) shall be 33 1/3 cents for each dollar excluded by subsection(a). The reduction described in subparagraph (F) in any passive activity credit carryover shall be 33 1/3 cents for each dollar excluded by subsection (a).

(4) Ordering rules

(A) Reductions made after determination of tax for year

The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) Reductions under subparagraph (A) or (D) of paragraph (2)

The reductions described in subparagraph (A) or (D) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.

(C) Reductions under subparagraphs (B) and (G) of paragraph (2)

The reductions described in subparagraphs (B) and (G) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.

(5) Election to apply reduction first against depreciable property

(A) In general

The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

(B) Limitation

The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(C) Other tax attributes not reduced

Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

(c) Treatment of discharge of qualified real property business indebtedness

(1) Basis reduction

(A) In general

The amount excluded from gross income under subparagraph (D) of subsection (a)(1) shall be applied to reduce the basis of the depreciable real property of the taxpayer.

(B) Cross reference

For provisions making the reduction described in subparagraph (A), see section 1017.

(2) Limitations

(A) Indebtedness in excess of value

The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of –

(i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

(ii) the fair market value of the real property described in paragraph (3)(A) (as of such time), reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

(B) Overall limitation

The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

(3) Qualified real property business indebtedness

The term "qualified real property business indebtedness" means indebtedness which –

(A) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property,

(B) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and

(C) with respect to which such taxpayer makes an election to have this paragraph apply.

Such term shall not include qualified farm indebtedness. Indebtedness under subparagraph (B) shall include indebtedness resulting from the refinancing of indebtedness under subparagraph (B) (or this sentence), but only to the extent it does not exceed the amount of the indebtedness being refinanced.

(4) Qualified acquisition indebtedness

For purposes of paragraph (3)(B), the term "qualified acquisition indebtedness" means, with respect to any real property described in paragraph (3)(A), indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

(5) Regulations

The Secretary shall issue such regulations as are necessary to carry out this subsection, including regulations preventing the abuse of this subsection through cross-collateralization or other means.

(d) Meaning of terms; special rules relating to certain provisions

(1) Indebtedness of taxpayer

For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness –

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case

For purposes of this section, the term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent

For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market

value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge. ((4) Repealed. Pub. L. 99-514, title VIII, Sec. 822(b)(3)(A), Oct. 22, 1986, 100 Stat. 2373)

(5) Depreciable property

The term "depreciable property" has the same meaning as when used in section 1017.

(6) Certain provisions to be applied at partner level

In the case of a partnership, subsections (a), (b), (c), and (g) shall be applied at the partner level.

(7) Special rules for S corporation

(A) Certain provisions to be applied at corporate level

In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level.

(B) Reduction in carryover of disallowed losses and deductions

In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

(C) Coordination with basis adjustments under section 1367(b)(2)

For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

(8) Reductions of tax attributes in title 11 cases of individuals to be made by estate

In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraphs (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

(9) Time for making election, etc.

(A) Time

An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

(B) Revocation only with consent

An election referred to in subparagraph (A), once made, may be revoked only with the consent of the Secretary.

(C) Manner

An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

(10) Cross reference

For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

(e) General rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency)

For purposes of this title –

(1) No other insolvency exception

Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

(2) Income not realized to extent of lost deductions

No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

(3) Adjustments for unamortized premium and discount

The amount taken into account with respect to any discharge shall be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.

(4) Acquisition of indebtedness by person related to debtor

(A) Treated as acquisition by debtor

For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the

Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

(B) Members of family

For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

(C) Entities under common control treated as related

For purposes of this paragraph, two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b).

(5) Purchase-money debt reduction for solvent debtor treated as price reduction If –

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur –

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.

(6) Indebtedness contributed to capital

Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital –

(A) section 118 shall not apply, but

(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

(7) Recapture of gain on subsequent sale of stock

(A) In general

If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245 –

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property,

(ii) the aggregate amount allowed to the creditor –

(I) as deductions under subsection (a) or (b) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange, shall be treated as an amount allowed as a deduction for depreciation, and

(iii) an exchange of such stock qualifying under section 354(a), 355(a), or 356(a) shall be treated as an exchange to which section 1245(b)(3) applies.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) Special rule for cash basis taxpayers

In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(C) Stock of parent corporation

For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(D) Treatment of successor corporation

For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(E) Partnership rule

Under regulations prescribed by the Secretary, rules similar to the rules of the foregoing

subparagraphs of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) Indebtedness satisfied by corporation's stock

For purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

(10) Indebtedness satisfied by issuance of debt instrument

(A) In general

For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.

(B) Issue price

For purposes of subparagraph (A), the issue price of any debt instrument shall be determined under sections 1273 and 1274. For purposes of the preceding sentence, section 1273(b)(4) shall be applied by reducing the stated redemption

price of any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter.

(f) Student loans

(1) In general

In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

(2) Student loan

For purposes of this subsection, the term "student loan" means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by –

(A) the United States, or an instrumentality or agency thereof,

(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,

(C) a public benefit corporation –

(i) which is exempt from taxation under section 501(c)(3),

(ii) which has assumed control over a State, county, or municipal hospital, and

(iii) whose employees have been deemed to be public employees under State law, or

(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made –

(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a).

The term "student loan" includes any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii).

(3) Exception for discharges on account of services performed for certain lenders

Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) if the discharge is on account of services performed for either such organization.

(g) Special rules for discharge of qualified farm indebtedness

(1) Discharge must be by qualified person

(A) In general

Subparagraph (C) of subsection (a)(1) shall apply only if the discharge is by a qualified person.

(B) Qualified person

For purposes of subparagraph (A), the term "qualified person" has the meaning given to such term by section 49(a)(1)(D)(iv); except that such term shall include any Federal, State, or local government or agency or instrumentality thereof.

(2) Qualified farm indebtedness

For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if –

(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

(3) Amount excluded cannot exceed sum of tax attributes and business and investment assets

(A) In general

The amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed the sum of –

(i) the adjusted tax attributes of the taxpayer, and

(ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(B) Adjusted tax attributes

For purposes of subparagraph (A), the term "adjusted tax attributes" means the sum of the tax attributes described in subparagraphs (A), (B), (C), (D), (F), and (G) of subsection (b)(2) determined by taking into account $3 for each $1 of the attributes described in subparagraphs (B), (C), and (G) of subsection (b)(2) and the attribute described in subparagraph (F) of subsection (b)(2) to the extent attributable to any passive activity credit carryover.

(C) Qualified property

For purposes of this paragraph, the term "qualified property" means any property which is used or is held for use in a trade or business or for the production of income.

(D) Coordination with insolvency exclusion

For purposes of this paragraph, the adjusted basis of any qualified property and the amount of the adjusted tax attributes shall be determined after any reduction under subsection (b) by reason of amounts excluded from gross income under subsection (a)(1)(B).

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26 U.S.C. § 1366. Pass-thru of items to shareholders

(a) Determination of shareholder's tax liability

(1) In general

In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's –

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) Nonseparately computed income or loss defined

For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) Character passed thru

The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or

incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder

In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions

(1) Cannot exceed shareholder's basis in stock and debt

The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of –

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions

Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(3) Carryover of disallowed losses and deductions to post-termination transition period

(A) In general

If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) Cannot exceed shareholder's basis in stock

The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) Adjustment in basis of stock

The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(D) At-risk limitations

To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder's amount at risk under section 465 if such increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).

(e) Treatment of family group

If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without

receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

(f) Special rules

(1) Subsection (a) not to apply to credit allowable under section 34

Subsection (a) shall not apply with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels).

(2),Treatment of tax imposed on built-in gains

If any tax is imposed under section 1374 for any taxable year on an S corporation, for purposes of subsection (a), the amount so imposed shall be treated as a loss sustained by the S corporation during such taxable year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

(3) Reduction in pass-thru for tax imposed on excess net passive income

If any tax is imposed under section 1375 for any taxable year on an S corporation, for purposes of subsection (a), each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of such tax as –

(A) the amount of such item, bears to

(B) the total passive investment income for the taxable year.

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26 U.S.C. § 1367. Adjustments to basis of stock of shareholders, etc.

(a) General rule

(1) Increases in basis

The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis

The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

(b) Special rules

(1) Income items

An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness

(A) Reduction of basis

If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis

If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d)

This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock

(A) In general

If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis

The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

UNITED STATES TAX COURT

DAVID A. and LOUISE A. GITLITZ,	)	
Petitioners,	)	DOCKET NO.
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

PETITION

Petitioners hereby petition for a redetermination of the deficiency as set forth by the Commissioner of Internal Revenue in her Notice of Deficiency dated January 10, 1996, and, as a basis for their case, allege as follows:

1. Petitioners David A. and Louise A. Gitlitz's mailing address is P.O. Box 1774, Aspen, Colorado 81611. Petitioners' legal residence is at 0845 Red Mountain Rd., Aspen, Colorado 81612. Petitioner David A. Gitlitz's taxpayer identification number is 045-42-6651. Petitioner Louise A. Gitlitz's taxpayer identification number is 259-72-4465. A joint tax return for the year ending December 31, 1991 was filed with the Internal Revenue Service Center in Ogden, Utah.

2. The Notice of Deficiency (a copy of which, including the statements and schedules accompanying the Notice, is attached hereto as Exhibit A) was mailed to

Petitioners on January 10, 1996, and was issued by the District Director of the Internal Revenue Service at Denver, Colorado.

3. The deficiency as determined by the Commissioner, is as follows:

TAX YEAR ENDED	TAX
December 31, 1991	$251,192

4. The determination of tax as set forth in the Notice of Deficiency is based upon the following errors:

a. The Commissioner erred when she determined in her Notice of Deficiency that Petitioners are not allowed an ordinary loss of $1,010,648 due to a lack of basis pursuant to Section 1366 (d) (1) of the Internal Revenue Code.

b. The Commissioner erred when she determined in her Notice of Deficiency that, because of the change in the amount of gross income resulting from the disallowance of the loss, a total itemized deduction of $419,493 is allowable, instead of the $449,812 as shown on the return.

5. The facts upon which Petitioners rely as the basis for their case are as follows:

a. Petitioner David A. Gitlitz was a shareholder of P.D.W. & A., Inc., a Colorado corporation, holding a 50% interest in the corporation.

b. P.D.W. & A., Inc. was a calendar year taxpayer.

c. P.D.W. & A., Inc. had properly and effectively elected to be taxed as an "S Corporation" under the provisions of Subchapter S of the Internal Revenue Code prior to 1991, and that election was effective during the year ending December 31, 1991.

d. P.D.W. & A., Inc. was a partner in Parker Properties Joint Venture.

e. Parker Properties Joint Venture realized $4,154,891 in cancellation of indebtedness income in 1991.

f. P.D.W. & A., Inc.'s distributive share of Parker Properties joint Venture's cancellation of indebtedness income in 1991 was $2,021,296.

g. At the time that Parker Properties Joint Venture realized this income, P.D.W. & A., Inc. was insolvent to the extent of $2,181,748.

h. Pursuant to Section 1367 (a) (1) of the Internal Revenue Code of 1986, Petitioner David A. Gitlitz was required to increase his basis in his P.D.W. & A., Inc. stock by the amount of his pro rata share of the cancellation of indebtedness income realized by P.D.W. & A., Inc.

i. Petitioner David A. Gitlitz's basis in his P.D.W. & A., Inc. stock, as properly computed, entitled him to take into account an ordinary loss in the amount of $1,010,648.

j. Therefore, the Commissioner incorrectly determined that Petitioner was not entitled to an ordinary loss in the amount of $1,010,648 pursuant to the basis limitation rules of Section 1366 (d) (1) of the Internal Revenue Code of 1986.

WHEREFORE, Petitioners pray that this Court may hear this case and determine that:

1. There is no deficiency in tax for the taxable year ending December 31, 1991;

2. The Commissioner erred in the statutory notice of Deficiency as alleged in each assignment of error set forth in this Petition;

3. The court grant such other and further relief to which Petitioners may be entitled.

DATED this 22nd day of March, 1996.

CHICOINE & HALLETT, P.S.

/s/ Darrell D. Hallett
Darrell D. Hallett, #HD0353

/s/ Larry N. Johnson
Larry N. Johnson, #JL0062

/s/ Robert J. Chicoine
Robert J. Chicoine, #CR0714

/s/ John M. Colvin
John M. Colvin, #CJ1464

1011 Western Avenue
Waterfront Place One, Suite 803
Seattle, Washington 98104
(206) 223-0800

illegible
District Director
Date: JAN 10 1996

Person to Contact:
L. Sandoval
Contact Telephone Number:
(303) 446-1306

Robert J Guerra
56550 Greenwood Plaza Blvd
Ste 107
Englewood, CO 80111

The enclosed material is furnished to you under the provisions of a power of attorney of other authorization you have on file with us. For our convenience we have listed below the name(s) of the taxpayer(s) to whom this material relates.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely Yours,

/s/ Walter A. Hutton Jr.
Walter A. Hutton Jr.
District Director

Enclosures:
Letters
Reports

Taxpayer(s)' Name(s):

David A Gitlitz
and Louise A Gitlitz
5575 DTC Parkway Ste 360
Englewood, CO 80111

David A Gitlitz
and Louise A Gitlitz
0845 Red Mountain Rd
Aspen, CO 81612

DEPARTMENT OF THE TREASURY
Internal Revenue Service
District Director

Date of This Notice:
Jan 10 1996
Letter Number 531
Taxpayer Identification Number:
045-42-6651
Form: 1040

David A Gitlitz
and Louise A. Gitlitz
5575 DTC Parkway Ste 360
Englewood, CO 80111

CERTIFIED LETTER

1321136

-NOTICE OF DEFICIENCY-

Dear Taxpayer:

We were unable to reach a satisfactory agreement in your case. This letter is your **NOTICE OF DEFICIENCY** as required by law. Our determination shows that you are liable for a deficiency (increase) in tax as follows:

TAX YEAR ENDED	DEFICIENCY	ADDITIONS TO THE TAX
December 31, 1991	$ 251,192	

The enclosed schedule of Income Tax Examination Changes shows how the deficiency was computed.

IF YOU AGREE with these deficiencies and which to limit the amount of interest,

1. Sign and date the enclosed waiver Form 807.
2. Return the signed waiver from to us in the enclosed envelope.

You will limit the amount of interest if you enclose payment with your signed waiver form. Any unpaid liability will continue to be charged interest.

IF YOU DO NOT AGREE with these deficiencies you may,

1. Petition the United States Tax Court for a redetermination of the deficiencies. You may receive a petition form by writing to:

   United States Tax Court
   400 Second Street, NW
   Washington, DC 20217

2. Send the completed petition form with a copy of this letter to the United States Tax Court. You must file your petition within 90 days from the above mailing date (150 days if addressed to you outside the United States). The time for filing a petition is fixed by law, and the court cannot consider your case if the petition is filed late.
3. If both of you wish to petition the Tax Court, both must sign the petition or each must file a separate, signed petition.

You may represent yourself before the Tax Court, or you may be represented by anyone admitted to practice before the Court.

If you decide not to sign and return the waiver, and you do not file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for the liability after 90 days from the mailing date of this letter (150 days if addressed to you outside of the United States).

If you have any questions about this letter, please call L. Sandoval at (303) 446-1306. If you wish to write us, please use the address below:

Internal Revenue Service
600 17th Street
MS4803DEN
Denver, CO 80202-2490

Please attach a copy of this letter to help us identify your account and include your telephone number and a convenient time for us to contact you if additional information is needed.

Sincerely,

Commissioner
By: /s/ Walter A. Hutton Jr.
Walter A. Hutton Jr.
District Director

cc: Robert J Guerra

Form 870

Department of the Treasury – Internal Revenue Service
Waiver of Restrictions on Assessment
and Collection of Deficiency in Tax and
Acceptance of Overassessment

Date received by IRS _____

Names and address of taxpayers
David A Gitlitz
and Louise A Gitlitz
5575 DTC Parkway Ste 360
Englewood, CO 80111

Social security or employer identification number
045-42-6651

Increase (Decrease) in Tax and Penalties

Tax Year Ended:	December 31, 1991
Deficiency:	
Increase in tax	$ 251,192

* * *

Instructions for Form 870

General Information

If you consent to the assessment of the deficiencies shown in this waiver, please sign and return the form in order to limit any interest charge and expedite the adjustment to your account. Your consent will not prevent you from filing a claim for refund (after you have paid the

tax) if you later believe you are so entitled. It will not prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.

We have agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the required State form.

If you later file a claim and the Service disallows it, you may file suit for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

We will consider this waiver a valid claim for refund or credit of any overpayment due you resulting from any decrease in tax and penalties determined by the Internal Revenue Service, shown above, provided you sign and file it within the period established by law for making such a claim.

Who must sign

If you filed jointly, both you and your spouse must sign. If this waiver is for a corporation, it should be signed with the corporation name, followed by the signatures and titles of the corporate officers authorized to sign. An attorney or agent may sign this waiver provided such action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (for example, an executor, administrator, or a trustee) Form 56, Notice Concerning Fiduciary Relationship, should, unless previously filed, accompany this form.

Department of the Treasury – Internal Revenue Service
Income Tax Examination Changes

Name and Address of Taxpayer

GITLITZ, DAVID A. & LOUISE A.
5575 DTC PARKWAY, STE 360

ENGLEWOOD CO 80111-

SS OR ❑ Number: 945-12-6651

Return Form No. 1040

Person with union examination changes were discussed

Name and Title

1.	Adjustments to Income	Tax Year End 12/31/91
A.	ITEMIZED DEDUCTIONS	$ 30,319.00
B.	POWER ALLOWED ORD LOSSES	1,010,648.00
	* * *	
2.	Total Adjustments	1,040,967.00

3.	Taxable Income Per Return or as Previously Adjusted	29,555.00
4.	Corrected Taxable Income	1,070,522.00
	Tax Method SCHEDULE D	
	Filing Status JOINT	
5.	Tax	295,333.00
6.	Additional Taxes	
7.	Corrected Tax Lability	295,333.00
8.	Less Credits	
A.	PRIOR YEAR MIN TAX CREDIT	12,921.00
B.		
C.		
D.		
9.	Balance (Line 7 less total of lines 8A through 8D)	282,412.00
10.	Plus Other Taxes	
A.	SELF EMPLOYMENT TAX	342.00
B.		
C.		
D.		
11.	Total Corrected Tax Liability (Line 9 + lines 10A to 10B)	282,754.00
12.	Total Tax Shown on Return or as Previously Adjusted	31,562.00

13. Adjustments to

A. SPECIAL FUELS CREDIT
B.

14. Deficiency – Increase in Tax or (Overassessment – Decrease in tax) (Line 11 less Line 12 adjusted by Line 13)
251,192.00

15. Adjustments to Prepayment Credits

16. Balance Due or Overpayment (Line 14 Adjusted by Line 15) (Excluding Interest and penalties)
$ 251,192.00

---

* * *

The Internal Revenue Service has agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the State form.

You may be subject to backup withholding if you underreport your interest, dividend, or patronage dividend income and do not pay the required tax. The IRS may order backup withholding at 31 percent after four notices have been issued to you over a 120-day period and the tax has been assessed and remain unpaid.

Summary of Taxes, Penalties and Interest:

A. Balance due or Overpayment of Taxes (line 16, page 1)

251.192.00

B. Penalties (line 18, page)
(Computed to 10/13/95)

C. Interest (IRC 6601)
(Computed to 10/13/95)

D. TMI Interest (computed to
10/13/95 on TMI underpayment)

E. Amount due or refund
(sum of lines A, B, C,
and D.) 251,192.00

Other Information:

Examiner's Signature
/s/ T McMahon
Theresa McMahon

District Denver

Date 09/13/95

TTES Ver. S3.94 Page 2 of 2 Form 4549A-C6 (Rev. 1-91)

David A Gitlitz
Louise A Gitlitz
90D:4803DEN

EXPLANATION OF ADJUSTMENTS
TAXABLE YEARS ENDING DECEMBER 31, 1991.

1A.

Due to the change in the amount of your adjusted gross income, a total itemized deduction of $419,493 is allowed instead of $449,812 as shown on your income tax return(s) for the taxable year(s) ended 1991. See exhibit A.

1B.

It is determined that you are not allowed an ordinary loss of $1,010,648 in tax years 1991 due to lack of basis under Internal Revenue Code Section 1366(d)(1).

EXHIBIT A 3013

Name Of Taxpayer: GITLITZ, DAVID A. & LOUISE 09/15/95
Identification Number: 045-42-5651 TOTAL 33.94

9112 SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	1,291.00	1,291.00	0.00
2. 0.075 of Adjusted Gross Income	35,953.00	111,751.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	54,324.00	54,324.00	0.00
5. Home Interest Expense	50,362.00	50,362.00	0.00
6. Investment Interest	224,054.00	224,054.00	0.00
7. Other Interest Expense	1,741.00	1,741.00	0.00
8. Total Interest Expense	276,157.00	276,157.00	0.00
9. Contributions	130,712.00	130,712.00	0.00
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	2,876.00	2,876.00	0.00
13. 0.020 of Adjusted Gross Income	9,587.00	29,800.00	
14. Excess Miscellaneous deductions	0.00	0.00	0.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15)	449,812.00	419,493.00	30,319.00

ITEMIZED DEDUCTIONS WORKSHEET

A.	Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	461,193.00
B.	Total of lines 3, 6, 10, (plus any gambling losses included on line 15)	224,054.00
C.	Line A less Line B	237,139.00
D.	Multiply the amount on line C by 80%	189,711.00
E.	Adjusted Gross Income from Form 1040	1,490,015.00
F.	$100,000 (or $50,000 if married filing separate)	100,000.00
G.	Line E less Line F	1,390,015.00
H.	Multiply the amount on Line G by 3%	41,700.00
I.	Enter the smaller of Line D or Line H	41,700.00
J.	Total Itemized Deductions (entered on line 16 above)	419,493.00

BEST AVAILABLE COPY

UNITED STATES TAX COURT

PHILIP D. and ELEANOR G. WINN, Petitioners,	)	DOCKET NO.
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

PETITION

Petitioners hereby petition for a redetermination of the deficiency as set forth by the Commissioner of Internal Revenue in her Notice of Deficiency dated January 10, 1996, and, as a basis for their case, allege as follows:

1. Petitioners Philip D. and Eleanor G. Winn's legal residence is at 4941 Nassau Circle, Englewood, Colorado 80110. Petitioner Philip D. Winn's taxpayer identification number is 047-12-0453. Petitioner Eleanor G. Winn's taxpayer identification number is 122-16-0566. A joint tax return for the year ending December 31, 1992 was filed with the Internal Revenue Service Center in Ogden, Utah.

2. The Notice of Deficiency (a copy of which, including the statements and schedules accompanying the Notice, is attached hereto as Exhibit A) was mailed to Petitioners on January 10, 1996, and was issued by the District Director of the Internal Revenue Service at Denver, Colorado.

3. The deficiency as determined by the Commissioner, is as follows:

TAX YEAR ENDED	TAX
December 31, 1992	$ 242,555

4. The determination of tax as set forth in the Notice of Deficiency is based upon the following errors:

a. The Commissioner erred when she determined in her Notice of Deficiency that Petitioners are not allowed a capital passive activity loss carryover of $21,638 from P.D.W. & A., Inc. because of adjustments to Petitioners' 1991 return, because the loss exceeded Petitioners' basis in P.D.W. & A., Inc., and because Sections 108(b) and (d)(7) of the Internal Revenue Code of 1986 provide for a reduction in the capital loss carryover.

b. The Commissioner erred when she determined in her Notice of Deficiency that Petitioners are not allowed an ordinary passive activity loss carryover of $989,010 from P.D.W. & A., Inc. because of adjustments to Petitioners' 1991 return, because the loss exceeded Petitioners' basis in P.D.W. & A., Inc., and because Sections 108(b) and (d)(7) of the Internal Revenue Code of 1986 provide for a reduction in the passive activity loss carryover.

c. The Commissioner erred when she determined in her Notice of Deficiency that, because of the change in the amount of gross income resulting from the disallowance of the losses, a total itemized deduction of $193,085 is allowable, instead of the $236,816 as shown on the return.

5. The facts upon which Petitioners rely as the basis for their case are as follows:

a. Petitioner Philip D. Winn was a shareholder of P.D.W. & A., Inc., a Colorado corporation, holding a 50% interest in the corporation.

b. P.D.W. & A., Inc. was a calendar year taxpayer.

c. P.D.W. & A., Inc. had properly and effectively elected to be taxed as an "S Corporation" under the provisions of Subchapter S of the Internal Revenue Code prior to 1991, and that election was effective during the year ending December 31, 1991. Effective January 1, 1992, P.D.W. & A., Inc. revoked its S Corporation status.

d. P.D.W. & A., Inc. was a partner in Parker Properties Joint Venture.

e. Parker Properties Joint Venture realized $4,154,891 in cancellation of indebtedness income in 1991.

f. P.D.W. & A., Inc.'s distributive share of Parker Properties Joint Venture's cancellation of indebtedness income in 1991 was $2,021,296.

g. At the time that Parker Properties Joint Venture realized this income, P.D.W. & A., Inc. was insolvent to the extent of $2,181,748.

h. Pursuant to Section 1367(a)(1) of the Internal Revenue Code of 1986, Petitioner Philip D. Winn was required to increase his basis in his P.D.W. & A., Inc. stock by the amount of his pro rata share ($1,101,648) of the cancellation of indebtedness income realized by P.D.W. & A., Inc.

i. Petitioner Philip D. Winn's basis in his P.D.W. & A., Inc. stock, as properly computed, entitled him to take into account additional losses in the amount of $1,010,648.

j. Petitioners were not able to utilize $21,638 in capital losses and $989,010 in ordinary losses in 1991 because of passive activity loss limitations.

k. The disallowed ordinary loss in the amount of $989,000 and the disallowed capital loss in the amount of $21,638 were properly carried over and taken into account in 1992.

l. The Commissioner, therefore, incorrectly determined that Petitioners were not entitled to a capital passive activity loss carryover in the amount of $21,638 and an ordinary passive activity loss carryover in the amount of $989,010.

WHEREFORE, Petitioners pray that this Court may hear this case and determine that:

1. There is no deficiency in tax for the taxable year ending December 31, 1992;

2. The Commissioner erred in the statutory Notice of Deficiency as alleged in each assignment of error set forth in this Petition;

3. The Court grant such other and further relief to which Petitioners may be entitled.

DATED this 22nd day of March, 1996.

CHICOINE & HALLETT, P.S.

/s/ Darrell D. Hallett
Darrell D. Hallett, #HD0353

/s/ Larry N. Johnson
Larry N. Johnson, #JL0062

/s/ Robert J. Chicoine
Robert J. Chicoine #CR0714

/s/ John M. Colvin
John M. Colvin, #CJ1464

1011 Western Avenue
Waterfront Place One,
Suite 803
Seattle, Washington 98104
(206) 223-0800

Date: JAN 10 1996

Person to Contact: L. Sandoval
Contact Telephone Number: (303) 446-1306

Robert J Guerra
56550 Greenwood Plaza Blvd
Ste 107
Englewood, CO 80111

The enclosed material is furnished to you under the provisions of a power of attorney or other authorization you have on file with us. For your convenience we have listed below the name(s) of the taxpayer(s) to whom this material relates.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely Yours,

/s/ Walter A. Hutton Jr.
Walter A. Hutton Jr
District Director

Enclosures:
Letters
Reports

Taxpayer(s)' Name(s):

Philip D Winn
and Eleanor G Winn
4941 Nassau Circle
Englewood, CO 80110

Philip D Winn
and Eleanor G Winn
5445 DTC Parkway Ste 300
Englwood, CO 80111

Philip D Winn
and Eleanor G Winn
5475 DTC Parkway Ste 300
Englwood, CO 80111

DEPARTMENT OF THE TREASURY
Internal Revenues Service
District Director

Date of This Notice: JAN 10 1995
Letter Number 531
Taxpayer Identification Number:
047-12-0453
Form: 1040

Philip D Winn
and Eleanor G Winn
4941 Nassau Circle
Englewood, CO 80110

CERTIFIED LETTER
132/139

– NOTICE OF DEFICIENCY –

Dear Taxpayer:

We were unable to reach a satisfactory agreement in your case. This letter is your **NOTICE OF DEFICIENCY** as required by law. Our determination shows that you are liable for a deficiency (increase) in tax as follows:

TAX YEAR ENDED	DEFICIENCY
December 31, 1992	$242,555

ADDITIONS TO THE TAX

The enclosed schedule of Income Tax Examination Changes shows how the deficiency was computed.

IF YOU AGREE with these deficiencies and wish to limit the amount of interest,

1. Sign and date the enclosed waiver Form 870.

2. Return the signed waiver form to us in the enclosed envelope.

You will limit the amount of interest if you enclose payment with your signed waiver form. Any unpaid liability will continue to be charged interest.

IF YOU DO NOT AGREE with these deficiencies you may,

1. Petition the United States Tax Court for a redetermination of the deficiencies. You may receive a petition form by writing to:

   United States Tax Court
   400 Second Street, NW
   Washington, DC 20217

2. Send the completed petition form with a copy of this letter to the United States tax Court. You must file your petition within *90 days* from the above mailing date (150 days if addressed to you outside the United States). The time for filing a petition is fixed by law, and the court cannot consider your case if the petition is filed late.

3. If both of you wish to petition the Tax Court, both must sign the petition or each must file a separate, signed petition.

You may represent yourself before the Tax Court, or you may be represented by anyone admitted to practice before the Court.

If you decide not to sign and return the waiver, and you do not file a petition with the tax Court within the time limit, the law requires us to assess and bill you for the liability after 90 days from the mailing date of this letter

(150 days if addressed to you outside of the United States).

If you have any questions about this letter, please call L. Sandoval at (303) 446-1306. If you wish to write us, please use the address below:

Internal Revenue Service
600 17th Street
MS4803DEN
Denver, CO 80202-2490

Please attach a copy of this letter to help us identify your account and include your telephone number and a convenient time for us to contact you if additional information is needed.

Sincerely,

Commissioner
By:

/s/ Walter A. Hutton Jr.
Walter A. Hutton Jr.
District Director

cc: Robert J Guerra
James I Massaro

Form 870

Department of the Treasury – Internal Revenue Service
Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment

Date received by IRS

Names and address of taxpayers
Philip D Winn
and Eleanor G Winn
4941 Nassau Circle
Englewood, CO 80110

Social security or employer identification number
047-12-0453

Increase (Decrease) in Tax and Penalties

Tax Year Ended:	December 31, 1992
Deficiency:	
Increase in tax	$ 242,555

* * *

Instructions for Form 870

General Information

If you consent to the assessment of the deficiencies shown in this waiver, please sign and return the form in order to limit any interest charge and expedite the adjustment to your account. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are so entitled. It will not prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.

We have agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the required State form.

If you later file a claim and the Service disallows it, you may file suit for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

We will consider this waiver a valid claim for refund or credit of any overpayment due you resulting from any decrease in tax and penalties determined by the Internal Revenue Service, shown above, provided you sign and file it within the period established by law for making such a claim.

Who must sign

If you filed jointly, both you and your spouse must sign. If this waiver is for a corporation, it should be signed with the corporation name, followed by the signatures and titles of the corporate officers authorized to sign. An attorney or agent may sign this waiver provided such action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (for example, an executor, administrator, or a trustee) Form 56, Notice Concerning Fiduciary Relationship, should, unless previously filed, accompany this form.

FORM 4549-A RETURN FORM 1040

DEPT. OF THE TREASURY-INTERNAL
REVENUE SERVICE
INCOME TAX EXAMINATION CHANGES

Name and Address of Taxpayer
Philip D Winn
Eleanor G Winn
4941 Nassau Circle
Englewood CO 80110

TIN 047-12-0453

Filing Status Joint

Person With Whom Changes Were Discussed

1.	ADJUSTMENTS TO INCOME:	Year: 1992
	A. Capital Gain or loss	$21,638.00
	B. Itemized deductions	$43,731.00
	C. PAL – PDWA Passive Ordinary loss	$989,010.00
	* * *	
2.	TOTAL ADJUSTMENTS	$1,054,379.00
3.	TAXABLE INCOME PER RETURN	$1,239,965.00
4.	CORRECTED TAXABLE INCOME	$2,294,344.00
5.	TAX	$660,783.00
6.	ALTERNATIVE TAX, IF APPLICABLE (From Page ___)	
7.	CORRECTED TAX LIABILITY	$660,783.00
8.	LESS: CREDITS:	

A. General Business Credit	$94,637.00
B. Foreign Tax Credit	$19.00
C.	
9. BALANCE	$566,127.00
10. PLUS: ADDITIONAL TAXES	
A. Self-employment tax	
B.	
C.	
11. TOTAL CORRECTED TAX LIABILITY	$566,127.00
12. TOTAL TAX AS PREVIOUSLY ADJ	$323,572.00
13. DEFICIENCY (line 12-line 13)	$242,555.00
14. OVERASSESSMENT (line 13-line 12)	
15. ADJUSTMENT TO PREPAYMENT CREDITS	
16. BALANCE DUE, Not including interest	$242,555.00
17. OVERPAYMENT, Not including interest	
18. PENALTIES, IF ANY (see explanation)	

Other Information

Philip D Winn
Eleanor G Winn
90D:4803DEN

EXPLANATION OF ADJUSTMENTS
TAXABLE YEARS ENDING DECEMBER 31, 1992.

1A.
A deduction for a capital passive activity loss carryover of $21,638 from P.D.W.&A Inc. is disallowed due to the

adjustments to your tax return for 1991, the fact that the loss exceeded your basis in P.D.W.&A. Inc., and that 108(b) and (d)(7) provide for a reduction in the capital loss carryover. Accordingly, taxable income is increased $21,638. See exhibit A.

1B.

Due to the change in the amount of your adjusted gross income, a total itemized deduction of $193,085 is allowed instead of $236,816 as shown on your income tax return(s) for the taxable year(s) ended 1992. See exhibit B.

1C.

A deduction for an ordinary passive activity loss carryover of $989,010 from P.D.W.&A., Inc., is disallowed due to the adjustments to your tax return for 1991, the fact that the loss exceeded your basis in P.D.W.&A. Inc., and that 108(b) and (d)(7) provide for a reduction in the passive activity loss carryover. Accordingly, taxable income is increased $989,010.

8A.

You are entitled to the general tax credit as provided by section 42 of the Internal Revenue Code. Accordingly, your tax is decreased $94,637. See exhibit C for computation.

EXHIBIT A

Name of Taxpayer: WINN, PHILIP D. & ELEANOR
Identification Number: 047-12-0453 TOTAL

09/13/95
$3.94

9212 SCHEDULE D - CAPITAL GAINS AND LOSSES

1. Short-term capital gain or loss	66,036.00	
2. Short-term capital loss carryover	0.00	
3. Net Short-term Gain or Loss (Add line 1 and 2)		66,036.00
4. Long-term capital gain or loss	1,418,662.00	
5. Long-term capital loss carryover	21,638.00	
6. Net long-term Gain or Loss (Add line 4 and 5)		1,440,500.00
7. Sum of lines 3 and 6 - Net Capital Gain or Loss		1,506,536.00
8. Capital loss limitation		0.00
9. Capital Gain or Loss - As Corrected		1,506,536.00
10. Capital Gain or Loss - Per Return		1,484,898.00
11. Line 9 less line 10 - Adjustment to Income		21,638.00

CORRECTED CARRYOVER

12. Short-term Carryover to Subsequent Year	0.00
13. Long-term Carryover to Subsequent Year	0.00

COMPUTATION OF ALTERNATIVE TAX

14. Taxable Income	2,294,344.00
15. Lesser of Long-Term Gain or Net Capital Gain	1,440,500.00
16. Line 14 less line 15	853,844.00
17. Alternative amount based on filing status	35,900.00
18. Greater of line 16 or line 17	853,844.00
19. Line 14 less line 18	1,440,500.00
20. Tax on line 18 using Rate Schedule	257,443.00
21. Line 19 multiplied by 28%	403,340.00
22. Line 21 plus line 20 - Alternative Capital Gain Tax	660,783.00

BEST AVAILABLE COPY

Name Of Taxpayer: WINN, PHILIP D. & ELEANOR 09/13/95
Identification Number: 047-12-0453 TOTAL 53.94

9212 SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	501.00	501.00	0.00
2. 0.075 of Adjusted Gross Income	110,759.00	186,557.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	46,988.00	46,988.00	0.00
5. Home Interest Expense	0.00	0.00	0.00
6. Investment Interest	62,284.00	62,284.00	0.00
7. Other Interest Expense	0.00	0.00	0.00
8. Total Interest Expense	62,284.00	62,284.00	0.00
9. Contributions	155,278.00	155,278.00	0.00
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	42,948.00	42,948.00	0.00
13. 0.020 of Adjusted Gross Income	29,536.00	49,749.00	
14. Excess Miscellaneous deductions	13,412.00	0.00	13,412.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15)	236,816.00	193,085.00	43,731.00

ITEMIZED DEDUCTIONS WORKSHEET

A.	Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	264,550.00
B.	Total of lines 3, 6, 10, (plus any gambling losses included on line 15)	62,284.00
C.	Line A less Line B	202,266.00
D.	Multiply the amount on line C by 80%	161,813.00
E.	Adjusted Gross Income from Form 1040	2,487,429.00
F.	$105,250 (or $52,625 if married filing separate)	105,250.00
G.	Line E less Line F	2,382,179.00
H.	Multiply the amount on Line G by 3%	71,465.00
I.	Enter the smaller of Line D or Line H	71,465.00
J.	Total Itemized Deductions (entered on line 16 above)	193,085.00

9212 FORM 3900 - GENERAL BUSINESS CREDIT

1.	Tentative Investment Credit	0.00
2.	Tentative Jobs Credit	0.00
3.	Tentative Alcohol Used as Fuel Credit	0.00
4.	Tentative Research Activities Credit	0.00
5.	Tentative Low Income Housing Credit	63,360.00
6.	Tentative Enhanced Oil Recovery Credit	0.00
7.	Tentative Disabled Access Credit	0.00
8.	Tentative Renewable Electricity Production Credit	0.00
9.	Current Year General Business Credit	63,360.00
10.	Passive Activity Credits included in lines 1 through 8	63,360.00
11.	Subtract line 10 from line 9	0.00
12.	Passive Activity Credits allowed in 1992	271,092.00
13.	Carrybacks and Carryovers	45,219.00
14.	Total Available Credit subject to Limitation	316,311.00
15.	Income Tax liability as adjusted	660,764.00
16.	General Business Credit Limitation	660,764.00
17.	General Business Credit as Corrected	94,637.00
18.	General Business credit available for carryover or carryback	221,674.00

Filed January 27, 2000

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 99-3209

UNITED STATES OF AMERICA

v.

HAROLD D. FARLEY;
GAIL D. FARLEY,

Appellants

Appeal from the United States District Court
for the Western District of Pennsylvania
(D.C. Civil Action No. 97-cv-00308E)
District Judge: Honorable Maurice B. Cohill, Jr.

Argued October 28, 1999

Before: MANSMANN, ROTH, and WEIS, Circuit Judges

(Opinion filed January 27, 2000)

Harry Litman, Esquire
United States Attorney
Loretta C. Argrett, Esquire
Assistant Attorney General
Teresa E. McLaughlin, Esquire
Edward T. Perelmuter, Esquire
(Argued)
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Attorney for Appellants

OPINION OF THE COURT

ROTH, Circuit Judge:

This case presents a question of statutory interpretation; its facts are not disputed. The appellants, Harold and Gail Farley, are taxpayers and owners of two separate S corporations. The Farleys obtained income tax refunds from the Internal Revenue Service in late 1995 and early 1996 after filing amended tax returns for the years 1989, 1990, 1992 and 1993. They obtained these refunds after adjusting the basis of their S corporation stock upward to account for discharge of indebtedness income excluded from gross income due to the insolvency of their S corporations. By increasing the basis of their S corporation stock, the Farleys were able to take deductions for losses that had been previously suspended. The recognition of these suspended losses resulted in a reduction of the Farley's tax liability for 1989, 1990, 1992 and 1993. In addition, through the same increase in basis, the Farleys were able to take advantage of losses in 1995 resulting in an additional reduction of tax liability. The I.R.S. issued refunds, reflecting these adjustments, but later decided that the Farleys could not utilize discharge of indebtedness income to increase the basis of their S corporation stock. As a consequence, the I.R.S. concluded that the

Farleys were not entitled to deductions for their suspended losses and thus were not entitled to the refunds issued in late 1995 and early 1996.

The Government subsequently brought suit in District Court to recover these refunds. Both parties moved for summary judgment. The District Court, relying primarily on *Nelson v. Commissioner*, 110 T.C. 114 (1998), granted the Government's motion for summary judgment. The Farleys appeal the District Court's grant of summary judgment.

Because we find that the District Court misinterpreted the relevant statutes in disallowing the refunds obtained by the Farleys, we will reverse the grant of summary judgment and remand this case to the District Court to enter judgment in favor of the Farleys.

I. FACTS

In 1986, the Farleys invested $200,000 and received fifty percent of the stock of two S corporations, SCI Acquisition, Inc. ("SCI") and CCI Camping Corporation ("CCI") (hereinafter referred to collectively as the "Farley S Corporations"). In 1986 and 1987, the Farley S Corporations incurred losses, which for tax purposes passed through to the Farleys. *See* 26 U.S.C. § 1366(a)(1) ("In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder's pro rata share of the corporation's . . . items of income (including tax-exempt income), loss, deduction, or credit the separate treatment

of which could affect the liability for tax of any shareholder . . . . ").[1] As a result of these losses, by the end of the 1987 tax year, the Farleys' S corporation stock had a zero basis.[2] From 1987 through 1992, the Farley S Corporations continued to incur losses. Because the Farleys' S corporation stock had a zero basis, the Farleys reported these losses as suspended losses on their tax returns (the

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[1] The concept of "pass-through" provides to S corporation shareholders some of the advantages of a partnership. It is perhaps best summarized by the following excerpt from a recent Tenth Circuit opinion: Subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361-1379, permits certain corporations to elect to be taxed in a similar, but not identical, fashion as partnerships. *See* 3 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts P 95.6.1 (2d ed. 1991) (highlighting major distinctions). A subchapter S corporation generally does not pay taxes as an entity. 26 U.S.C. § 1363(a). Instead, the corporation's profits and losses pass through directly to its shareholders on a pro rata basis and are then reported on the shareholders' individual tax returns. 26 U.S.C. § 1366(a). This conduit approach allows shareholders to avoid double taxation on corporate earnings. Tax integrity, meanwhile, is preserved by requiring shareholders to treat all income and deductions as if "realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." 26 U.S.C. § 1366(b). *Gitlitz v. Commissioner*, 182 F.3d 1143, 1146 (10th Cir. 1999).

[2] The tax basis of an asset, in this case the Farleys' S corporation stock, is typically the asset's cost. To determine the basis of an S corporation's stock, a taxpayer starts with the cost of the stock and increases his or her basis for corporate income and loans to the corporation. *See* 26 U.S.C. § 1367(a)(1). Similarly, the taxpayer decreases his or her basis for corporate losses and distributions by the corporation. *See* 26 U.S.C. § 1367(a)(2). It was this deduction of corporate losses from basis which had reduced the Farley's S corporation stock to zero basis.

"Suspended Losses"). *See* 26 U.S.C. § 1366(d)(1)(A) ("[The] aggregate amount of losses and deductions taken into account by a shareholder under [§ 1366(a)] for any taxable year shall not exceed . . . the adjusted basis of the shareholder's stock in the S corporation."); 26 U.S.C. § 1366(d)(2) ("Any loss or deduction which is disallowed for any taxable year by reason of [§ 1366(d)(1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.").

In 1992, the Farley S Corporations ceased operating due to their continued losses, and, as a result, the Farley S Corporations' secured creditors foreclosed on the assets of SCI and CCI. All debt not satisfied by the sale of these assets was forgiven by the secured creditors, resulting in discharge of indebtedness income (also known as cancellation of debt income) to the Farley S Corporations (the "COD Income"). From this point on, the Farley S Corporations were insolvent, and, as such, the COD Income was excluded from gross income. *See* 26 U.S.C. § 108(a)(1)(B).

On or around April 15, 1990, the Farleys filed their income tax return for the 1989 tax year. The 1989 Return disclosed a tax liability of $67,507, which the Farleys paid. On or around April 15, 1991, the Farleys filed their income tax return for the 1990 tax year. The 1990 Return disclosed a tax liability of $112,553, which the Farleys paid. On or around April 15, 1993, the Farleys filed their income tax return for the 1992 tax year. The 1992 Return disclosed a tax liability of $42,936, which the Farleys paid. On or around April 15, 1994, the Farleys filed their income tax return for the 1993 tax year. The 1993 Return disclosed a tax liability of $44,748, which the Farleys

paid. Finally, on or around October 11, 1996, the Farleys filed their income tax return for the 1995 tax year. The 1995 Return disclosed a tax liability of $0.

On September 1, 1995, and January 12, 1996, the Farleys filed amended tax returns for tax years 1989, 1990, 1992 and 1993 (together, the "Relevant Tax Years"). As a part of the Amended Returns, the Farleys claimed refunds for the Relevant Tax Years as follows: 1989 – $67,507; 1990 – $64,522; 1992 – $42,936; and 1993 – $44,748.

The Amended Returns were premised on an increase in the tax basis of the Farleys' S corporation stock as a consequence of COD income. Through this increase in tax basis, the Farleys were able to recognize the Suspended Losses and consequently reduced their tax liability for each of the Relevant Tax Years. In addition, through the same increase in basis, the Farleys were able to take deductions for losses in the 1995 tax year. The I.R.S. issued refunds in the amounts claimed by the Farleys (the "Relevant Refunds").

Shortly thereafter, in two undated letters (the "30 Day Letters") from Frank P. Nixon, District Director of the I.R.S., by I.R.S. Agent Robert V. Grosso, the I.R.S. proposed certain assessments. Along with the 30 Day Letters, the Farleys were provided with a series of reports authored by Grosso, which concluded that the Relevant Refunds were erroneously issued and therefore the Refund Claims were disallowed. According to the Grosso Reports, pursuant to the controlling statutes, the Farleys could not increase the tax basis of their S corporation

stock even though the Farley S Corporations had discharge of indebtedness income; they could not, therefore, recognize the Suspended Losses; and ultimately they could not claim refunds for the Relevant Tax Years nor take a deduction for the losses in 1995.

The 30 Day Letters proposed tax liability as follows: 1989 - $67,507; 1990 - $64,522; 1992 - $42,918; 1993 - $44,748; and 1995 - $92,980. By agreement between Grosso and the Farleys' accountant, the parties set July 31, 1997, as the last day to protest the issues raised by the 30 Day Letters. The Farleys promptly protested the assessments in the 30 Day Letters, and shortly thereafter the Government brought suit in U.S. District Court for the Western District of Pennsylvania seeking recovery of the Relevant Refunds.

In District Court, the Farleys moved for summary judgment, and the Government cross-moved for summary judgment. In their initial motion for summary judgment, the Farleys relied primarily upon *Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997) (*Winn I*). *Winn I* was squarely on point and supported the Farleys' position, but the Tax Court chose to re-visit the issue en banc in a different case, *Nelson v. Commissioner*, that presented the same question. After re-visiting the issue, the Tax Court's opinion in *Winn I* was withdrawn and superseded by a subsequent opinion issued the same day as the Tax Court's opinion in *Nelson v. Commissioner*. *See Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997) withdrawn and superseded by *Winn v. Commissioner*, 75 T.C.M. (CCH) 1840 (1998); *Nelson v. Commissioner*, 110 T.C. 114, 130 (1998). Relying on *Nelson*, which was affirmed by the Tenth Circuit Court of Appeals, the District Court in this case granted the Government's

motion for summary judgment. *See United States v. Farley*, 99-1 U.S.T.C. ¶ 50, 370 (1999); *see also Nelson v. Commissioner*, 182 F.3d 1152, 1152-53 (10th Cir. 1999) ("For the same reasons outlined in our published opinion filed today in *Gitlitz v. Commissioner* . . . we affirm the decision of the Tax Court."); *Gitlitz v. Commissioner*, 182 F.3d 1143, 1151 (10th Cir. 1999) (holding that discharge of indebtedness income excluded from gross income under 26 U.S.C. § 108(a) does not pass through to the shareholders of an S Corporation and thus does not increase the shareholder's basis in their S corporation stock). The Farleys appeal the District Court's ruling.

II. JURISDICTION

This action was filed by the Government pursuant to § 7405(b) of the Internal Revenue Code. Section 7405(b) of the Internal Revenue Code provides the Government with a civil cause of action to recover taxes "erroneously refunded." 26 U.S.C. § 7405(b); *see, e.g., Hutchins v. Internal Revenue Service*, 67 F.3d 40, 42 (3d Cir. 1995).

The District Court had subject matter jurisdiction over this case pursuant to 28 U.S.C. § 1331 (1999), and we have appellate jurisdiction pursuant to 28 U.S.C. § 1291 (1999). *See* 28 U.S.C. § 1331 (1999) ("The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States."); 28 U.S.C. § 1291 (1999) ("The courts of appeals . . . shall have jurisdiction of appeals from all final decisions of the district courts of the United States. . . . "). Our review of the District Court's grant of summary judgment is plenary. *See, e.g., Hurley v. Atlantic City Police Dept.*, 174 F.3d 95, 128 n.29 (3d Cir. 1999).

III. DISCUSSION

A. Recovery of Refunds Under Section 7405(b)

Before reaching the merits of the taxpayers' argument, we address the Farleys' contention that the Government cannot sue pursuant to 26 U.S.C. § 7405(b) to recover the Relevant Refunds. Section 7405(b) states in pertinent part that "[a]ny portion of a tax imposed by this title which has been erroneously refunded . . . may be recovered by civil action brought in the name of the United States." 26 U.S.C. § 7405(b). Noting that "[t]here has never been any assertion that [the Relevant Refunds] were mistakenly issued," the Farleys argue that the Relevant Refunds were not "erroneously refunded" within the meaning of the statute and that the Government therefore cannot sue to recover the Relevant Refunds pursuant to § 7405(b). Instead, the Farleys contend, the Government must proceed under 26 U.S.C. § 6212 to recover the Relevant Refunds. The Farleys argue that "[t]he facts of this case are squarely on point with the facts of *United States v. Russell Mfg. Co.*, 349 F.2d 13 (2d Cir. 1965)," and as such the Government is precluded by the holding in *Russell* from suing to recover the Relevant Refunds pursuant to 26 U.S.C. § 7405(b). While the Farleys' argument is not entirely without merit, we conclude that the Government can bring suit pursuant to § 7405(b) to recover the Relevant Refunds. In addition, while we are obviously not bound by Second Circuit precedent, it is important to note that even if we were to adopt the reasoning of the Russell court, the Farleys' argument still fails because the facts of this case are not "squarely on point with the facts of" *Russell*.

The controversy that gave rise to *United States v. Russell Mfg. Co.* began in 1945 when Russell Manufacturing Company took a $47,200 deduction for payments made to two separate trusts. *Russell*, 349 F.2d at 15. The Commissioner of Internal Revenue disallowed the deduction, concluding that:

> [The] payments were not pursuant to a "qualified" plan under § 23(p)(1)(A), (B) and (C) of the 1939 Code . . . and that they did not meet the requirement of § 23(p)(1)(D) which permits deductions of payments under a non-qualified plan "if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid."

Id. Upon denial of the refund claim, Russell Manufacturing sued in the Court of Claims and ultimately prevailed. *See Russell Mfg. Co. v. United States*, 175 F. Supp. 159, 163 (Ct. Cl. 1959).

After prevailing in the Court of Claims, Russell Manufacturing continued to claim similar refunds for many years. The I.R.S. issued these refunds but decided in 1964 to bring suit in the District Court pursuant to § 7405(b) to recover the refunds, alleging that the refunds had been issued erroneously. *See United States v. Russell Mfg. Co.*, 245 F. Supp. 159 (D. Conn. 1964). The District Court dismissed the Government's claim, concluding that the Government could not sue under § 7405(b) because the money claimed by the Government had not been "erroneously refunded." *See id.* at 160. The Government promptly appealed the District Court's ruling, and the Second Circuit affirmed, concluding that the Government

could not sue pursuant to § 7405(b). *See Russell*, 349 F.2d at 19. The facts of *Russell*, however, differ dramatically from the facts in this case.

Unlike this case, in *Russell*, the Government "candidly" admitted that "[i]ts aim [was] to obtain a decision by [the Second Circuit Court of Appeals] conflicting with that of the Court of Claims, as to which Russell might well obtain certiorari under Supreme Court Rule 19, subd. 1(b), and thus to procure an authoritative construction, hopefully in the Government's favor." *Russell*, 349 F.2d at 16. In addition, unlike this case, the parties in *Russell* were the same in the Court of Claims as in the Court of Appeals. In arguing that the facts of this case are "squarely on point with the facts of *United States v. Russell Manufacturing Co.*, 349 F.2d 13 (2nd Cir. 1965)," the Farleys analogize the earlier Court of Claims decision in *Russell* to the Tax Court's initial decision in *Winn v. Commissioner*. In *Russell*, the taxpayer in the Court of Claims and the Second Circuit Court of Appeals was the same – Russell Manufacturing Company. In contrast, the taxpayers in *United States v. Farley* (Third Circuit Court of Appeals) and *Winn v. Commissioner* (Tax Court) were clearly different. The final and perhaps most important point is that the court in *Russell* explicitly limited its holding to the facts of that case stating, "[w]e limit our decision to the unusual facts here presented, where the Government deliberately made what it then considered an erroneous refund to a taxpayer prevailing in a court decision whose authority remains unimpaired." *Russell*, 349 F.2d at 17-18 (emphasis added). The Farleys' reliance on *Russell* is misplaced; *Russell* is inapposite because the

Government in this case did not change its treatment of tax refunds in order to prompt litigation.

Indeed, this case is more appropriately analogized to *United States v. Ellis*, 154 F. Supp. 32 (S.D.N.Y. 1957), *aff'd* 264 F.2d 325 (2d Cir. 1959), *United States v. Heilbroner*, 22 F. Supp. 368 (S.D.N.Y. 1938) *aff'd* 100 F.2d 379 (2d Cir. 1938), or *United States v. Tuthill Springs Co.*, 55 F.2d 415 (N.D. Ill. 1931) in which the I.R.S. changed its interpretation of the substantive law. However, unlike *Russell*, in *Ellis*, *Heilbroner*, and *Tuthill*, the court held that the Government could sue under the predecessor of § 7405(b) to recover refunds erroneously issued. As such, we conclude that the Government can bring this suit under § 7405(b) of the Internal Revenue Code in an effort to recover the Relevant Refunds.

B. The Pass Through of the Discharge of Indebtedness Income

Turning to the merits of the Farleys' appeal, we focus first on the statutory language of the Internal Revenue Code. Section 61(a)(12) of the Internal Revenue Code states in relevant part, "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness." 26 U.S.C. § 61(a)(12). This background rule, that discharge of indebtedness income is income, does not apply to insolvent taxpayers. Specifically, § 108(a)(1)(B) of the Internal Revenue Code states that "gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of

indebtedness of the taxpayer if . . . the discharge occurs when the taxpayer is insolvent." 26 U.S.C. § 108(a)(1)(B).

The exclusion of discharge of indebtedness income from gross income provided for in § 108(a)(1)(B) is not without a price. A taxpayer excluding discharge of indebtedness income from gross income must make corresponding reductions in certain tax attributes, attributes that might otherwise yield future tax benefits. Pursuant to § 108(b)(1) of the Internal Revenue Code, "[t]he amount excluded from gross income under [§ 108(a)(1)(b)] shall be applied to reduce tax attributes of the taxpayer as provided in [§ 108(b)(2)]." 26 U.S.C. § 108(b)(1). Discharge of indebtedness income is thus offset against the various "tax attributes" listed in § 108(b)(2) – net operating losses, general business credits, minimum tax credits, capital loss carryovers, basis (to the extent permitted under Section 1017(b) of the Internal Revenue Code), passive activity loss and credit carryovers, and foreign tax credit carryovers. *See* 26 U.S.C. § 108(b)(2)(A)-(G).[3]

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[3] The parties in this case do not dispute that an S corporation can have only two of the tax attributes listed in § 108(b)(2) – the basis of the S corporation's assets and § 1366(d)(1) losses, which are considered net operating losses under § 108(d)(7)(B) and as such are subject to reduction pursuant to § 108(b)(2)(A). *See* 26 U.S.C. § 108(d)(7)(B) ("In the case of an S corporation, for purposes of [§ 108(b)(2)(A)], any loss or deduction which is disallowed for the taxable year of the discharge under § 1366(d)(1) shall be treated as a net operating loss for such taxable year."). All other "tax attributes" listed in § 108(b)(2)(A)-(G) pass through to S corporation shareholders pursuant to § 1366(a)(1).

In challenging the District Court's grant of summary judgment, the Farleys argue that discharge of indebtedness income excluded from gross income under 26 U.S.C. § 108(a) passes through to the shareholders of an S corporation on a pro rata basis pursuant to § 1366 of the Internal Revenue Code. As support for this argument, the Farleys cite § 1366(a)(1)(A) of the Internal Revenue Code, which states that the determination of an S corporation's shareholder's tax liability for the shareholder's tax year during which the S corporation's tax year ends takes into account the shareholder's pro rata share of the S corporation's "items of income (including tax exempt income), loss, deduction, or credit, the separate treatment of which could affect the liability for tax of any shareholder." 26 U.S.C. § 1366(a)(1)(A). The Farleys also cite § 1366(c) of the Internal Revenue Code, which states that "in any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation." 26 U.S.C. § 1366(c).

The Farleys further argue that discharge of indebtedness income, after passing through to the shareholders of the S corporation pursuant to § 1366, increases the basis of the shareholders' stock pursuant to § 1367. Specifically, under § 1367(a)(1)(A), an S corporation's shareholder's basis in the stock of the corporation is increased for any period by, inter alia, items of income described in § 1366(a)(1)(A). *See* 26 U.S.C. § 1367(a)(1)(A). As § 1367(a)(1)(A) states, "[t]he basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period: the

items of income described in subparagraph (A) of § 1366(a)(1). . . . " 26 U.S.C. § 1367(a)(1)(A).

As the preceding discussion demonstrates, the key to unraveling this case is understanding how the relevant statutory provisions interact. As discussed above, § 1366, which describes how and when income, losses, deductions and credits pass through to S corporation shareholders, and § 1367, which sets forth the framework for increasing and decreasing the basis of S corporation stock, must be read in conjunction with the § 108.

As mentioned above, § 108(a)(1) provides that "[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayers if . . . the discharge occurs when the taxpayer is insolvent." 26 U.S.C. § 108(a)(1). It is not disputed that the Farley S Corporations were insolvent at the time of the discharge of indebtedness. And as discussed above, discharge of indebtedness income excluded from gross income pursuant to § 108(b) offsets various tax attributes listed in § 108(b)(2). Pursuant to § 108(b)(4)(A), the reduction in tax attributes mandated by § 108(b)(2) is made after the determination of the tax imposed on the taxpayer (the S corporation shareholder) for the year of discharge. *See* 26 U.S.C. § 108(b)(4)(A) ("The reduction made in [§ 108(b)(2)] shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.") (emphasis added). Furthermore, pursuant to § 108(d)(7)(A), discharge of indebtedness income exclusions (§ 108(a)) and tax attribute reduction principles (§ 108(b)) must be applied at the corporate level. *See* 26 U.S.C. § 108(d)(7)(A) ("In the case of an S

corporation, [§ 108(a) and § 108(b)] shall be applied at the corporate level.").

The ultimate disposition of this case hinges on the interaction of § 108(d)(7)(A) with § 108(b)(4)(A). Section 108(d)(7)(A), which states that the discharge of indebtedness income exclusion and tax attribute reduction principles should be applied at the corporate level, has two primary effects. First, § 108(d)(7)(A) requires the solvency determination in § 108(a)(1)(b) to be made at the corporate level. That is, when determining whether the "taxpayer is insolvent," and thus whether discharge of indebtedness income is excluded from gross income, one must determine whether the S corporation itself is insolvent, not whether a specific individual shareholder is insolvent. Second, and more importantly, § 108(d)(7)(A) requires that the tax attribute reduction principles set forth in § 108(b) be applied at the corporate level. That is, when reducing tax attributes as required by § 108(b), discharge of indebtedness income excluded from gross income pursuant to § 108(a)(1)(A) shall be applied to reduce the tax attributes of the corporation, rather than the individual shareholder.

Section 108(b)(4)(A) states that "[t]he reductions described in [§ 108(b)(2)] shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." 26 U.S.C. § 108(b)(4)(A) (emphasis added). As the Tenth Circuit observed in *Gitlitz*:

> The outcome of this case is ultimately determined by the timing of the pass-through. If the attribute reduction procedures precede the pass-through, the corporation's excluded discharge

> of indebtedness income is absorbed before it can pass through to shareholders and compel basis adjustments. . . . If, on the other hand, attribute reduction takes place after the pass-through, the taxpayers' theory must prevail.

Gitlitz v. Commissioner, 182 F.3d 1143, 1148 (10th Cir. 1999).[4]

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[4] Contrary to our holding today, in *Gitlitz*, the Tenth Circuit held that COD income excluded from gross income under § 108 did not pass through to the S corporation's shareholders and therefore did not increase the basis of their S corporation stock. *See Gitlitz*, 182 F.3d at 1151. The Tenth Circuit concluded that the timing of pass-through under § 1366 ultimately determined the outcome of the appeal. *See id.* at 1148. The court further concluded that attribute reduction under § 108(b) preceded the pass-through of excluded COD income and, as such, the S corporation's COD income was absorbed before it could pass through to the shareholders and increase the basis of their S corporation stock. *See id.* According to the Court, this construction avoided potential windfalls. *See id.* at 1148-49.

The court in *Gitlitz* had difficulty determining the role of § 108(b)(4)(A) in the tax calculation and ultimately concluded that § 108(b)(4)(A) was simply designed to compute certain tax applications (such as establishing ceilings for deductions and credits under § 108(b)(2), charitable contribution limits, alternative minimum tax liability, etc.) before reducing tax attributes. *See id.* at 1150. Thus, the court did not read the statute as mandating attribute reductions in the tax year following the year of the discharge. *See id.* However, the Tenth Circuit conceded that if it read § 108(b)(4) narrowly and in isolation, the taxpayers' argument was plausible, that is, that Congress intended tax attributes to be reduced only in the tax year following the taxable year of the discharge. *See id.* The court refused to do so, however, finding that it was required to read the Internal Revenue Code as a whole, so as not to " 'defeat the object intended to be accomplished.' " *Id.* (citation omitted). Thus, the court concluded that the taxpayers' interpretation of

The language in § 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of the discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward. Discharge of indebtedness income, considered income under § 61(a)(12), is excluded from gross income pursuant to § 108(a)(1)(B) if, as in this case, the S corporation is insolvent. This solvency determination is made at the corporate level rather than the individual shareholder level pursuant to § 108(d)(7)(A). Discharge of indebtedness income excluded from gross income under § 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to § 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholders' S corporation stock pursuant to § 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally, the tax attribute reduction required by § 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by § 108(b)(4)(A).

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§ 108(b)(4)(A) would negate the effect of the tax attribution scheme and result in an unwarranted windfall to the taxpayers. *See id.*

The Tenth Circuit's interpretation of § 108(b)(4)(A) in *Gitlitz* ignores the plain meaning of the statute. Because wefind that the language of § 108(b)(4)(A) is clear and unambiguous, we decline to follow the Tenth Circuit's holding in *Gitlitz* and hold that COD income excluded from gross income under § 108 passes through to the S corporation's shareholders, increasing the basis of their S corporation stock.

We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable year of discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by § 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under § 1366(d)(1). As such, the Farleys were entitled not only to increase the basis of their S corporation stock but also to take deductions for the Suspended Losses.

C. The Government's Contentions

While we hold that the District Court erred in disallowing the Relevant Refunds, we will address some of the arguments advanced by the Government in their brief and at oral argument. The Government initially argues that the District Court's grant of summary judgment was appropriate because a contrary holding would provide the Farleys with "unwarranted double tax benefits," an unjustified tax "windfall," or a tax benefit not "intended" by the statute. Although one could argue that the outcome mandated by the statutory language was not the outcome intended by Congress, we have nevertheless found that the statutory language is clear and

unambiguous.[5] Moreover, other than *Gitlitz*, the Government cites no case to support its assertion that if the Farleys prevail, they will receive "unwarranted double

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[5] The term "unwarranted" or "unjustified" is used in the sense that the taxpayers have not borne any economic outlay for the tax benefit of their basis increase. Although tax policy generally dictates that a taxpayer is only entitled to an increase in basis for his investment of after-tax dollars, numerous exceptions to that rule exist. *See* James D. Lockhart and James E. Duffy, Tax Court Rules in Nelson That S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis, 10 J. S Corporation Tax'n 256 (Winter 1999), reprinted in 25 Wm. Mitchell L. Rev. 287, 303 (1999). For example, under §§ 101 and 103 of the Internal Revenue Code, tax-exempt income derived from certain life insurance contracts and state and local bonds purchased by an S corporation is passed through to shareholders under §§ 1366 and 1367 thus producing an increase in the basis of the S corporation's stock without any direct economic outlay by the shareholder. *See* James D. Lockhart and James E. Duffy, Tax Court Rules in Nelson That S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis, 25 Wm. Mitchell L. Rev. 287, 303-04 (1999). Since Congress has seen fit to allow "unwarranted" tax benefits under §§ 101 and 103, and since the statutory language in § 108 (with respect to COD income excluded from gross income) is identical to that in §§ 101 and 103, § 108 cannot be distinguished from §§ 101 and 103 on the basis of economic outlay considerations. *See id.* at 306. Nonetheless, to the extent that application of the relevant statutes results in a "perceived" unwarranted windfall, principles of judicial restraint dictate that the statute be applied as written unless such application would create an absurd result." *See id.* (citing *Exxon Corp. v. Commissioner*, 102 T.C. 721, 727-28 (1994)). Even the Tenth Circuit in *Gitlitz*, which concluded that Congress did not intend to grant the taxpayers the equivalent of a double deduction and ultimately held for the Government on facts virtually identical to those presented here, acknowledged that the "taxpayer's argument [wa]s not without merit." *Gitlitz*, 182 F.3d at 1148.

tax benefits" or an unjustified tax "windfall." In addition, the Government presents scant evidence that a decision in favor of the taxpayers would provide them with a tax benefit not intended by Congress. With the exception of the legislative history of the Omnibus Budget Reconciliation Act, which we discuss *infra*, the Government's initial argument finds little support in the case law or elsewhere.

The Government next argues that the taxpayers' argument is flawed because "it effectively reads §§ 108(b)(2)(A) and 108(d)(7)(B) – which require excluded discharge of indebtedness income to reduce S corporation net operating losses for the taxable year of discharge – out of the Code." In support of this proposition, the Government cites *Gitlitz* in which the court stated that the "[t]axpayers' interpretation of § 108(b)(4)(A) would negate the effect of the tax attribution scheme and would give taxpayers an unwarranted windfall." *Gitlitz*, 182 F.3d at 1150. The Government's argument is, however, flawed. Nothing in § 108(d)(7)(B) "require[s] excluded discharge of indebtedness income to reduce S corporation net operating losses for the taxable year of discharge;" in fact, nothing in § 108(d)(7)(B) even suggests such a conclusion. Section 108(d)(7)(B) states:

> In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under § 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to

> any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

26 U.S.C. § 108(d)(7)(B).

As we see from this language, § 108(d)(7)(B) does state that losses or deductions disallowed in the taxable year of discharge pursuant to § 1366(d)(1) must be considered net operating losses for the year of taxable discharge pursuant to § 108(b)(2)(D). However, nowhere does § 108(d)(7)(B) indicate that S corporation discharge of indebtedness income should reduce such net operating losses "for the taxable year of discharge." While this conclusion is an integral part of the Government's argument, it finds no support in the language of the statute.

As a corollary to the above argument, the Government suggests that because S corporations do not have most of 17 the tax attributes listed in § 108(b)(2) (for example, general business credits, minimum tax credits, or capital loss carryovers), the Farleys' interpretation of § 108(b)(4)(A) negates the effect of the tax attribute reduction scheme detailed in § 108(a)-(b). This argument misses the mark for two reasons.

First, § 108(a)-(b) is not specific to S corporations; it applies to partnerships and C corporations as well. As such, even if § 108(b)(2) is superfluous in part with respect to S corporations, it does not imply that the entire tax attribute scheme set forth in § 108(a)-(b) is negated by the Farleys' interpretation of § 108(b)(4)(A). Even though some parts of § 108(a)-(b) are inapplicable to S corporations, these parts may be applicable to C corporations or partnerships.

Second, S corporations typically do have at least one of the tax attributes listed in § 108(b)(2), mainly basis in the S corporation's assets. Thus, the tax attribute reduction scheme set forth in § 108(a)-(b) is not negated by the Farleys' interpretation of § 108(b)(4)(A), but rather is implemented by reducing the basis of an S corporation's assets. The Government counters by noting that under § 1017(b)(2), basis cannot be reduced below the debt secured by the assets. While this is true, and while an insolvent S corporation may likely have incurred as much secured debt as possible (thus leaving no basis above the amount of debt secured by its assets to be reduced), it is certainly possible for an S corporation to incur enough unsecured debt to become insolvent, while maintaining basis in its assets above the amount of debt secured by those assets. In such a situation, discharge of indebtedness income would reduce the basis of the S corporation's assets pursuant to §§ 108(b)(2) and 108(b)(4)(A) on the first day of the tax year following the year of the discharge of indebtedness. Thus, to quote *United States v. Nordic Village, Inc.*, it is possible to construe the statute "in such fashion that every word has some operative effect." *United States v. Nordic Village, Inc.*, 503 U.S. 30, 36 (1992); *cf.* Brief for Appellee at 41, *United States v. Farley*, No. 99-3209 (citing *Nordic Village* as support for the proposition that "a statute must, if possible, be construed in such fashion that every word has some operative effect").

The Government next argues that when § 1366(a)(1)(A) is read in conjunction with § 108(d)(7)(A), it is clear that discharge of indebtedness income does not pass through to the shareholders of an S corporation. The Government contends that "section 108 of the Code bars

taxpayers from receiving deductions for their suspended losses." The Government argues (consistent with the Tenth Circuit's holding in Gitlitz) that when discharge of an S corporation's indebtedness is excluded from income due to the S corporation's insolvency, the shareholder's pro rata share of the discharge of indebtedness income does not pass through to the shareholders but rather is either completely absorbed by the S corporation's net operating losses or, if not completely absorbed, is disregarded. Specifically, the Government argues that § 1366(b), which requires that "the character of an item passed through under § 1366(a)(1)(A) is determined as if realized 'directly from the source from which realized by the corporation' . . . cannot be applied to an item of income that is excludable at the corporate level." This argument, however, also misses the mark. It is not disputed that tax attributes are reduced at the corporate level; the question is when the reduction occurs. If the reduction occurs after the pass through of discharge of indebtedness income, as the Farleys argue and as the language of § 108(b)(4)(A) requires, then the shareholders of an S corporation can adjust their basis upward and deduct otherwise undeductible loses.

To bolster its argument, however, the Government refers to § 1366(b)[6] and quotes the Tax Court's opinion in *Nelson v. Commissioner*, in which Judge Beghe stated:

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[6] Section 1366(b) provides that the character of each tax "item" in § 1366(a)(1)(A) is determined as if it were realized directly from the source from which the S corporation realized it or incurred in the same manner as incurred by the S corporation. *See* 26 U.S.C. § 1366(b).

"Section 1366(b) refutes [the taxpayer's] passthrough interpretation of § 108(d)(7)(A). There's no way, actually or fictively, in which the equivalence rule of § 1366(b) could apply to a solvent shareholder of an insolvent S corporation." *Nelson*, 110 T.C. 114, 131-32 (Beghe, J., concurring) (1998). This statement, made without elaboration by Judge Beghe, is simply incorrect. Section 1366(b) can and does apply and does so "fictively" as required by the statute. *See* 26 U.S.C. § 1366(b) ("The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.") (emphasis added).

The Government next argues that the "[t]axpayer's construction of the Code" places § 108(d)(7)(A) in conflict with § 1366(b). According to the Government, "[i]n the case of discharge of indebtedness income realized by an insolvent S corporation with a solvent shareholder," a situation that is fairly common and almost certainly was envisioned by Congress, "section 108(d)(7)(A) would mandate that the income would be excludable from gross income, while § 1366(b) would mandate that the income would be taxable." Once more, however, the Government's argument is flawed. Section 1366(b) deals with the character of income which has been passed through to the shareholder, while § 108(d)(7)(A) deals with the application of the discharge of indebtedness income exclusion requirement and tax attribute reduction scheme detailed in §§ 108(a)-(b). These two statutory provisions address different issues at different levels.

The Government goes on to argue that "[t]he double tax benefit advocated by taxpayers in this case . . . is [ ] fundamentally at odds with the structure of Subchapter S." The Government argues that no other type of income (taxable or tax-exempt) realized by an S corporation results in the double tax benefit argued for by the Farleys. As mentioned earlier, §§ 101 and 103, in conjunction with §§ 1366 and 1367, generate tax-exempt income that results in an apparent "double tax benefit" for S corporation shareholders. *See supra* note 5. Even if the Government's argument were correct, it does not provide us with the freedom to ignore the unambiguous statutory language.

Both the taxpayers and the Government argue extensively about whether, in the case of an insolvent S corporation, discharge of indebtedness (or COD) income is tax-exempt income. It is beyond dispute that discharge of indebtedness income of an insolvent S corporation is "income" under § 1366. The taxpayers argue that discharge of indebtedness income is tax-exempt income while the Government argues that discharge of indebtedness income is not tax-exempt income but rather tax-deferred income. The taxpayers in making their argument rely on the legislative history of the Subchapter S Revision Act of 1982, which states with respect to § 1366:

> The following examples illustrate the operation of the bill's pass-through rules. . . . Tax exempt interest will pass through to the shareholders as such and will increase the shareholders' basis in their subchapter S stock. Subsequent

> distributions will not result in taxation of the tax-exempt income.

S. Rep. No. 97-640, at 16 (1982).[7]

However, this disagreement between the Government and the Farleys as to the nature of discharge of indebtedness income has little relevance. As Judge Beghe correctly noted in his concurrence in *Nelson*:

> No extended exegesis to determine the character of COD [Income] of an insolvent S corporation as "tax-exempt income," or as "deferred income," or as an unrealized "tax nothing" is needed. . . . The only relevant inquiry under § 1366 is not whether COD excluded from gross income of an insolvent S corporation is "tax-exempt income," but whether it's a passthrough item at all.

Nelson v. Commissioner, 110 T.C. 114, 130, 134 (1998) (Beghe, J., concurring); *cf. Gitlitz v. Commissioner*, 182 F.3d 143, 151 n.7 (10th Cir. 1999) ("We assume here that excluded discharge of indebtedness is tax-exempt income.").

The statute is clear – all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation pursuant to § 1366(a)(1)(A). In the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by § 108(a) increases the shareholder's basis in their S corporation stock after it passes through to the shareholders of the

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[7] It is undisputed that if discharge of indebtedness income is treated like tax-exempt interest, the taxpayers must prevail. *See* S. Rep. No. 97-640, at 16 (1982).

corporation. This allows shareholders to take deductions for S corporation losses previously suspended under § 1366(d)(1).

The Government's argument, that discharge of indebtedness income is not tax-exempt income but rather tax-deferred income, is not without merit. However, beyond citing one Senate Report that suggests Congress intended to defer taxes on discharge of indebtedness income, the Government's argument is not compelling. *See* S. Rep. No. 96-1035, 96th Cong. 2d Sess. 2, 1980-2 C.B. 620, at 625 ("[T]he rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge."). Ultimately, the Government argues that since discharge of indebtedness income is sometimes deferred, it should always be considered tax-deferred income. This argument suffers from one critical weakness – as the Government concedes, discharge of indebtedness income is sometimes tax-exempt.[8] If discharge of indebtedness income is sometimes tax-exempt income and sometimes tax-deferred income, it is hard to see how the Government concludes, without more support for its position, that discharge of indebtedness income is simply tax-deferred income.

The parties in this case also devote a substantial amount of time to analyzing the legislative history of

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[8] Even under the Government's theory, if discharge of indebtedness income for a given taxable year is greater than suspended losses/net operating losses, the amount by which discharge of indebtedness income exceeds suspended losses/net operating losses is disregarded and thus is tax-exempt.

various statutory provisions. Delving into the legislative history is unnecessary because the statutes' language is unambiguous. Furthermore, the available legislative history either conflicts with or does not directly address the question presented in this case. While the legislative history is as a whole unhelpful, we briefly address two pieces of legislative history which do bear on the issue now before us.

The legislative history of the Subchapter S Revision Act of 1982, in providing examples of pass-through, states with respect to § 1366 that:

> Tax exempt interest will pass through to the shareholders as such and will increase the shareholder's basis in their subchapter S stock. Subsequent distributions by a corporation will not result in taxation of tax-exempt income.

S. Rep. No. 97-640, at 16 (1982). The legislative history of the Subchapter S Revision Act goes on to state that, with respect to § 1367, "both taxable and not taxable income and deductible and nondeductible expenses will serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation." *Id.* at 18.[9] Put simply, discharge of indebtedness income, if treated like tax-exempt interest, passes through to the shareholders of an S corporation and increases the shareholder's basis in the stock. And as the Tenth Circuit in *Gitlitz* concluded:

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[9] Unlike § 1366(a)(1)(A) which references tax-exempt income, the legislative history cited above references taxable and non-taxable income, thus encompassing both tax-exempt and tax-deferred income.

> The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation. Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.

Gitlitz, 182 F.3d at 1148. As such, the Senate Report quoted above provides persuasive support for the Farleys' argument.

Also relevant is the legislative history of the Omnibus Budget Reconciliation Act of 1993, in which Congress extended the § 108 discharge of indebtedness exclusion to income from the discharge of "qualified real property business indebtedness." 26 U.S.C. § 108(a)(1)(D). The House Report on the Omnibus Budget Reconciliation Act explains in detail the effect of qualified real property business indebtedness on a shareholder's basis in the stock of an S corporation:

> In applying this provision to income from the discharge of indebtedness of an S corporation . . . the exclusion and basis reduction are both made at the S corporation level (§ 108(d)(7)). The shareholders' basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level. As a result of these rules, if an amount is excluded from the income of an S

> corporation under this provision, the income flowing through to the shareholders will be reduced (compared to what the shareholders' income would have been without the exclusion). Where the reduced basis in the corporation's depreciable property later results in additional income (or a smaller loss) to the corporation because of reduced depreciation or additional gain (or smaller loss) on disposition of the property, the additional income (or smaller loss) will flow through to the shareholders at that time, and will then result in a larger increase (or smaller reduction) in the shareholder's basis than if this provision had not previously applied. Thus, the provision simply defers income to the shareholders.

H.R. Rep. No. 103-111, at 624-25 (1993) reprinted in 1993 U.S.C.C.A.N. 378, 855-56.

The language in the legislative history could be interpreted, as the Government suggests, to mean that discharge of indebtedness income does not pass through to shareholders of an S corporation and therefore does not allow shareholders to increase the basis of their S 24 corporation stock. As one commentator has noted, however, "[w]ere this interpretation applied to all discharges of debt (and not just discharges under Section 108(a)(1)(D)), it could be viewed as a change in pre-existing law." Richard M. Lipton, IRS Challenges S Corporation Basis Increase for COD Income, 81 J. Tax'n 340, 344 (Dec. 1994). When the Internal Revenue Service first addressed this issue in TAM 9423003 (Feb. 28, 1994), which was issued many months after the enactment of the 1993 legislation, it made no mention of the legislative history cited above. *See id.* If the Internal Revenue Service

really viewed the language in § 108(a)(1)(D) as a change in pre-existing law, certainly it would have taken that position in TAM 9423003. Its failure to do so is telltale.

Moreover, we find significance in the fact that Congress, in enacting the 1993 legislation, did not make any changes to §§ 1366 and 1367. Thus, a plausible interpretation of the legislative history of § 108(a)(1)(D) is that it "applies solely for purposes of an S corporation's election to exclude COD income on the discharge of qualified real property business indebtedness – by its terms, it does not apply to discharges of other types of debt." Richard M. Lipton, IRS Challenges S Corporation Basis Increase for COD Income, 81 J. Tax'n 340, 344 (Dec. 1994). It seems unlikely, therefore, that Congress, by commenting on the application of one section of the Internal Revenue Code (§ 108), intended to determine how basis adjustments are made under another section (Subchapter S), especially where the language of the legislative history is inconsistent with the plain meaning of the statute.

Together, these two conflicting pieces of legislative history are the only ones that directly address the issue presented in this case. Ultimately, as the Tenth Circuit Court of Appeals observed, the legislative history is "largely unhelpful." *Gitlitz*, 182 F.3d at 1148. Although many other pieces of legislative history are cited by the Government, the Farleys, and commentators writing on this subject, the legislative history as a whole conflicts and provides little insight. And, as discussed earlier, the legislative history is unnecessary and irrelevant to our holding here – the statutory language is clear and unambiguous.

IV. Conclusion

Because we conclude that the District Court ignored the unambiguous language of the controlling statutes in granting the Government's motion for summary judgment, we will reverse the District Court's grant of summary judgment[10] and remand the case to the District Court to enter judgment in favor of the Farleys.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

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[10] We are aware that the result reached today in interpreting the relevant statutory language may not have been the result intended by Congress. However, we are not free to disregard the clear and unambiguous language of the controlling statutes. It is the function of this court to interpret the statutory language as written. If policy considerations suggest that the Code should be amended, Congress can do so. We may not.